United States Court of Appeals

for the Second Circuit

EXHIBITS

76-7278

Page E-1 to Page E-282

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 76-7278

B

MARGARET MARY McDONNELL MURPHY,

Plaintiff-Appellant,

against

McDONNELL & CO., INCORPORATED and THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, President,

Defendants.

JAMES F. McDONNELL, JR., individually, as Trustee under the Will of James F. McDonnell and as Executor of the Estate of Anna M. McDonnell, and CHARLES E. McDONNELL, as Executor of the Estate of Anna M. McDonnell,

Plaintiff-Appellants,

against

THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, THE NEW YORK STOCK EXCHANGE, INC., THE AMERICAN STOCK EXCHANGE by H. VERNON LEE, JR., Secretary, and McDONNELL & CO., INC.,

Defendants.

UNITED STATES COURT OF APPEALS
FILED
OCT 12 1976
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

JOINT APPENDIX OF EXHIBITS

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October 8, 1976.

PAGINATION AS IN ORIGINAL COPY

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PLAINTIFFS' EXHIBIT 77 IN EVIDENCE

77

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

FORM I STATEMENT

OF

NEW YORK STOCK EXCHANGE

- - - - - - - - - - - - -

ANNUAL AMENDMENT NO. 270

May 31, 1968

- - - - - - - - - - - - -

VOLUME I

PLAINTIFFS' EXHIBIT 77 IN EVIDENCE

(c) What security transactions on the floor of the exchange are not reported?

Transactions in odd-lots of stock and in less than $1,000 principal amount of bonds as well as transactions on a "seller's option" basis are not reported on the tape unless a specific request is approved by a Floor Official. Special transactions, such as those in bonds in denominations other than those deliverable on regular contracts, bonds from which required coupons are missing, etc., are not printed on the tape except by specific direction of a Floor Official.

It is possible that transactions may be omitted from the tape in error particularly during times of exceptional market activity.

20. State the policy of the exchange with respect to limitation or prohibition of listing or trading in any security on the exchange within a specified period after the issuance thereo

It is a settled practice of the Exchange not to admit to dealings on the Exchange new securities of a class not previously listed, if (1) the Exchange has knowledge that a distribution of such securities is in process; or (2) when such securities have been underwritten and publicly offered, until the Exchange finds that the underwriting syndicate or selling group has been terminate

An exception to these settled practices may, however, be made when the new security is the subject of a subscription right which has been offered to holders of a listed security.

AGREEMENTS

21. Does the exchange agree (without waiving any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of Title I of the Securities Exchange Act of 1934 and any amendment thereto and any rule or regulation made or to be made thereunder?

The New York Stock Exchange hereby agrees, upon the express understanding that such agreement shall not be construed as a waiver of any constitutional right of the Exchange or any member thereof to contest the validity of any provisions of the Securities Act of 1934 or of any rule or regulation made pursuant thereto, to comply and to enforce so far as within its powers compliance by its members with the provisions of Title I of the Securities Exchange Act of 1934 and any amendment thereto and any rule or regulation made or to be made thereunder.

PLAINTIFFS' EXHIBIT 79 IN EVIDENCE

00577

79 XD

NEW YORK STOCK EXCHANGE
ELEVEN WALL STREET
NEW YORK, N.Y. 10005

ROBERT W. BISHOP

March 18, 1968

PLF EX 168-D.
2/12/74

McDonnell & Co. Incorporated
120 Broadway
New York, N.Y. 10005

Attention: Mr. T. Murray McDonnell, Pres.

Gentlemen:

The financial questionnaire completed for your firm in February by Lybrand Ross Bros & Montgomery as of October 26, 1967 has just been brought to my attention.

Despite the length of time taken by your accountants to complete this questionnaire, I note that there are still very substantial figures reported for securities failed to deliver and receive from unidentified brokers, unidentified transfers and other unlocated securities differences, and error accounts. Such figures unresolved for such a long period of time indicate a serious lack of control of your firm's business arising from its bookkeeping.

I also note a memorandum in our files of a visit by Mr. McKay and your auditors here on December 26, 1967 requested by us because of the late filing. At that time we understood that McDonnell was planning to open two new offices. However, Mr. McKay was told that unless a membe organization was able to process its work on a current basis its business should be reduced, not expanded. As we have not received any additional applications for new offices we assume that your firm followed this advice to Mr. McKay. However, we would like more complete assurance on the progress which your firm is making in improving its record-keeping and steps which you are taking to contain the volume of your business.

Also, I have noted that you are planning a change in computer equipment during the spring. Our experience is that firms approaching a conversion should make sure that their records are in excellent order before the conversion begins.

All of these matters lead us to believe that McDonnell & Co. should seriously reappraise whether additional steps should be taken at present to limit new business and improve records. Would you please

OWN YOUR SHARE OF AMERICAN BUSINESS

PLAINTIFFS' EXHIBIT 79 IN EVIDENCE

arrange a meeting with Mr. W. E. Jones to give us a more complete picture of what you are doing toward both objectives. As preparation for this meeting please complete the enclosed questionnaire, and also prepare a list of people whom you have in preparation for registration or whom you have made commitments to hire as registered representatives.

Pending this meeting, the Exchange will not approve any new branch offices, and will restrict approval of registered representatives to those for whom applications are now on hand. Meantime, also, your firm should not make any further plans or commitments of any kind which would increase your business.

Sincerely yours,

Robert W. Haack

(enc)

PLAINTIFFS' EXHIBIT 72 IN EVIDENCE

01064

9/3/68

TO: Mr. G. H. Newman

FROM: R. A. Greves

SUBJECT: McDonnell & Co., Inc.

72

We have had numerous communication with the subject corporation in the past concerning Arbitrage transactions which include rights.

In their most recent letter dated August 28, 1968 they disagree with the treatment accorded to 2,334 shares of Recognition Equipment.

In the analysis the examiner reported that arbitrage treatment was not allowed on the 2,334 shares of Recognition Equipment valued at proceeds of $194,091 resulting from the sale of same. The securities were sold on a "regular way" basis settling subsequent to the questionnaire date. The examiner further states that proceeds of sale are not allowed as a credit item until settlement date on "regular way" sale transactions.

McDonnell & Co., Inc. states that the above should be considered as a valid arbitrage position not subject to penalty and gives their reasons as follows:

"In our position as rights specialist on the Exchange, in order to maintain a viable market, we must trade in all securities related to rights. Recognition Equipment Rts. were exercisable for Recognition Equipment Units which were, in turn, exchangeable into Corporation "S" common and Recognition Equipment Common. While the Units Recognition Equipment and Corporation "S" common traded on a "when issued" basis, Recognition Equipment common did not. Thus, while our books indicate a long position of 2,334 shares of Recognition Equipment common, no exposure existed on these shares on June 27th, as they had been sold regular way, the only trading market which existed.

We maintain that arbitraged positions should be valued for capital purposes on a trade date basis, although this is not in accordance with Rule 325(c)(1)(C)(7). The same circumstances arose in connection with our questionnaire of March 31st, 1966. We refer you to our letter addressed to Mr. Edward F. Nelson, dated June 13th, 1966, and his letters of June 9th and June 21st, 1966.

Back 9/1/68—

NS14.

BEST COPY AVAILABLE

PLAINTIFFS' EXHIBIT 72 IN EVIDENCE

As a result of these letters, we met at the Exchange with Messrs. Waterbury, Meentemeier, Jones and Nelson, our firm being represented by the writer, Mr. Owen W. Jaeger, Mr. James Laheney, and by our auditors, Lybrand, Ross Bros. & Montgomery, Mr. Alvin J. Mentzel.

There was recognition of the logic of our position by the Exchange representatives, but the problem was the provision of Rule 325 above cited. The matter was taken under advisement, and was in abeyance.

In an examination subsequent to our response to a questionnaire as of June 29, 1967, your examiner, Mr. J. A. Levonas, commented on a similar situation related to Continental Oil Co. stock, pointing out that a computation in accordance with the provision of Rule 325 above cited, our capital ratio would have been 2121%, but that, allowing the position as arbitraged, our capital ratio was 1670%. However, in the accompanying letter signed by Mr. Greves, no comment was made.

We would like to resolve this problem if possible since the less favorable interpretation could materially affect our function as rights specialist and will be happy to meet with you at your convenience."

Attached is certain related material taken from the Q-file.

In view of McDonnell's request that we resolve this problem, I would appreciate your advising how to proceed.

Richard A. Greves

Richard A. Greves.

NS 15

PLAINTIFFS' EXHIBIT 96a IN EVIDENCE

96a D

[PLAINTIFF EXHIBIT 96 -- Retyped]

9/4/68

Hank.

Once again we state that the treatment accorded these positions are in agreement with Rule 325 and frankly I don't see why we should attempt to change the rule because of McDonnell's activities in rights. Other brokers have the same situation, i.e. they are long various securities at any given date which have been sold regular way and are uncleared and we give the same prescribed treatment.

If McD's activities in this area are so large that it is necessary to get special treatment to meet capital requrements then I think they need more capital in their business.

/s/ L.E.W.

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Original]

33A

01202

10/25/68

McDonnell & Co.

3/15/68 – Restrictions letter.
No. B.O. – No RRs except where applications are in hand.
No. plans or commitments of any kind that would increase business.

4/2/68 – No transfer of RRs from other Firms
No new RRs except those in training
~~No commitments of any kind other than to~~
~~present accounts~~

4/5/68 – Firm initiated restrictions – ____
reduce advt. – underwriting participations,
firm trading

4/17/68 – Firm letter – report of systems and progress in resolving differences
a) Error Acct. Balances – 390 old items – 40 days to resolve
b) C.O. S.R. bills – 30 days
c) Non Current & DK Fails – 18 days to get current
e) 4 Suspense Accts – 1 acct – 32
2 accts. in 9 days and 1 acct. in 20 days

NS 567A

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Original]

01203

Dividends - no projection.

letter also requested lifting of restrictions of 4/2/68

4/15/68 Restrictions lifted - conditioned -
A) Until backlog cleared up:
1) Supplementary report
a) Are rates of correction being maintained?
b) Are any new backlogs developing?
c) Has dividend area been cleared up?
d) Progress and problems in conversion.

*** B) "Restrictions might be reimposed if your operations fall behind or progress on resolving your backlog diminishes."

5/10/68 — Firm letter. — progress report.
Error Acct — 193 items vs. 390
S.R dif's. — 259 vs. 690
D.K. Fails — $407,340 vs. $1,917,028
Sus. Accts — 2 out of 4 current — 1 not. week.
Dividends — new system being developed.

NS-5 for 8-12

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Original]

01204

III.

5/10/68 - Firm letter - continued.
☹ Will have complete count 5/18 weekend
☺ Plan full operation of 360/40
on first accounting day in June - 2 week
[illegible] - delivery postponed from May
May postpone to July
Current on daily data processing output.

6/20/68 - "we are still current in our record keeping

6/13/68 - Firm letter - progress report
Error Acct. - 89 vs. 193 vs. 390
S.R. diff. - None vs. 259 vs. 690
D.K. Fails - $287,803 FD
304,011 FR
Sus. Accts - 3 out of four current. -
one remaining has 23 items 19,970 long / 9,940 short
Divs. - further deterioration.
Random counts - + div. counts

NS 5691

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Original]

01205

7/16/18 – Firm letter –

A. Error Acct – 14 items left

B. S.R diff – None but no count has been made – planned after 7/27 conversion.

C. D.K. Fails – $169,000 vs. $304,011 del
$260,000 vs. $287,803 rec

E. Sus. Acct. – 3 out of 4 –
27 items 19,264 long / 19,516 short

F. Dividends – no substantial improvement.

8/14/18 Firm letter – SOQ – progress report

A. Error Acct. – Current

B. S.R. diff. – no complete count yet, thus no known differences – cannot promise count until converted. –

* * 360/40 operative 7/27

C. D.K. Fails – $189,391 vs $169,000 rec
23,930 vs 269,000 del.

E. Sus. Accts – remaining acct. – 0 long / 9,610 short

F. Dividends – continues to be problem

NS 570

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Original]

01206

V.

9/12/68 Firm letter

A. Error Acct. — current

B. S.R. diff. — no complete count. now appears unlikely that we will be able to operate under new system for at least 2 months

C D.K. Fails Rec. — $87,190
Del — 19,723

E. Sus. Acct. — 4 items — $7,037 short.

F. Divs. continues a problem.

10/14/68 Firm letter.

A. Error Acct. — current.

B. S.R. diff. — no complete count. — none feasible until corrected — now looks like 11/30

C. D.K fails — $80,496 rec
112,699 del.

E. Sus. Accts — same as last month

F. Dividends — still a problem.

NS571

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Original]

E-13

0120

FIRM: McDonnell & Co. Inc.

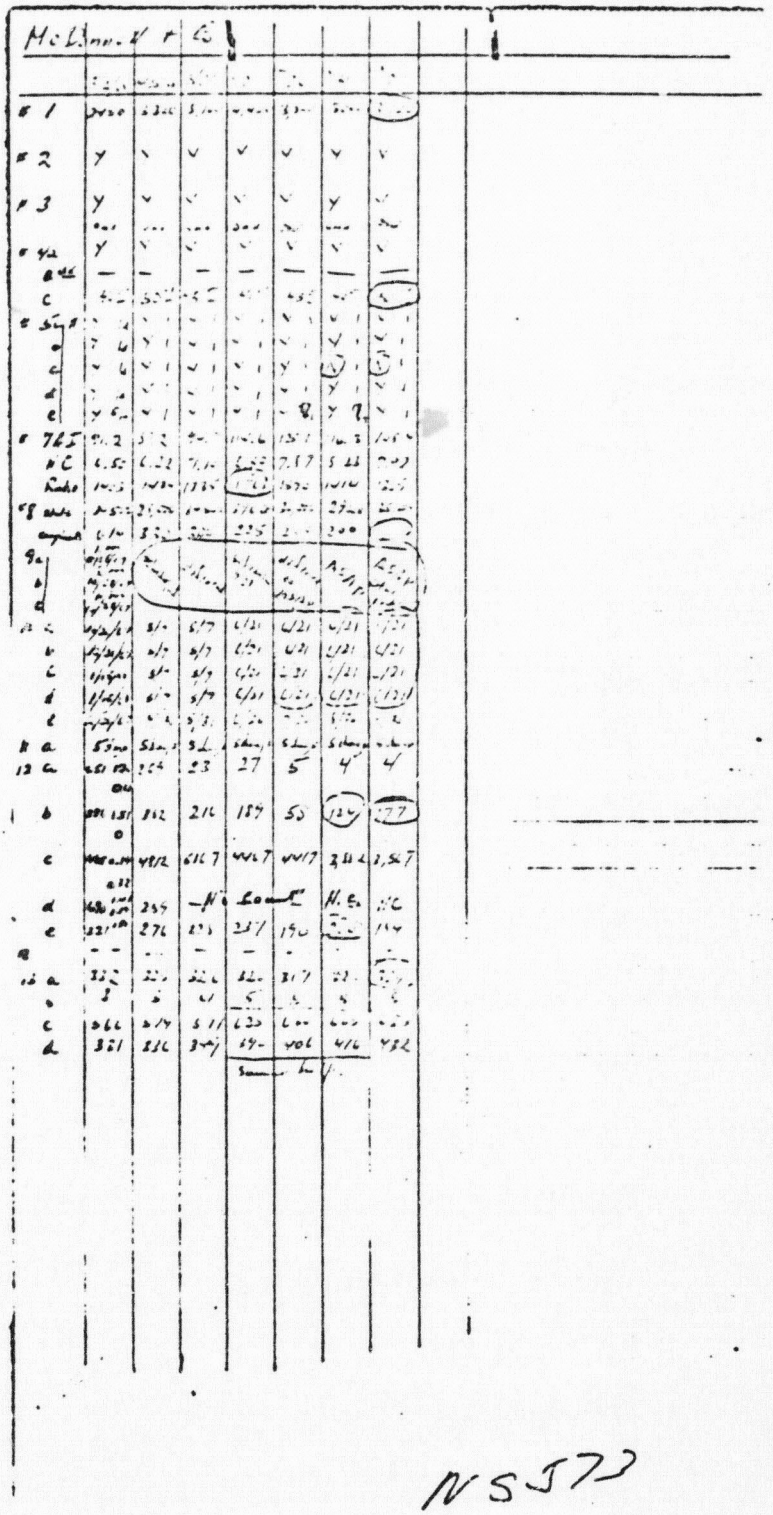
Fails

	F.D.	F.R.	F.D./F.R.	30 DAYS F.D.	30 DAYS F.R.	30 DAYS F.D./F.R.	F.D. 30 days E.D. Total	1	2	3	4	5
April	14.62	17.03	86	3.92	4.38	90	26.8	19.1	28.1	14.8	30.0	
May	19.08-	22.83-	84+	5.53-	5.70-	97-	25.0-	17.5	21.2	15.9	22.4	
June	27.56-	29.78-	93-	7.71-	7.78-	99-	28.0+	11.9	16.2	22.9	36.8	
July	32.28-	31.75-	102-	10.27-	8.83-	117-	32.1-	22.1	29.6	12.5	37.6	
August	24.48-	19.78+	124-	7.48-	7.82+	95+	30.5+	16.9	32.9	26.3	40.0	
September	21.74-	20.57+	111+	6.91-	6.68+	107-	31.7-	12.3	31.4	43.9	44.3	
October	18.20	24.32	75	5.51	5.96	92	30.3	24.4	24.5	42.9	36.3	
November	20.74	27.28	76	6.20	8.80	71	29.8	15.2	20.2	19.9	43.5	
December	25.55	35.17	73	7.32	9.99	73	28.7	22.8	11.2	29.3	39.8	
January												
February												
March												

NS 572

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Original]

01208



PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Retype]

33A ~~ID~~
01202
10/25/68

McDonnell & Co.

3/18/68 - Restrictions letter

No. B.U. - No RRs except where applications are in hand

No. plans or commitments of any kind that would increase business.

4/2/68 - No transfers of RRS from other firms

No new RRS except those in training

~~No commitments of any kind which would tend to increase business~~

4/5/68 - Firm initiated restrictions -

reduce advt. - underwriting participations, firm trading

4/17/68 - Firm letter - report of systems and progress in resolving differences

a) Error Acct. Balances - 390 old items - 40 days to resolve

b) 690 S.R. diff. - 30 days

c) Then Current & DK Fails - 18 days to get current

e) 4 Suspense Accts - 1 acct - 32
2 accts. in 9 days and 1 acct. in 20 days.

NS 567 A

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Retype]

01203

f) Dividends - no projection.

letter also requested lifting of restrictions of 4/2/68

4/19/68 - Restrictions lifted. - conditioned -

A) Until backlog cleared up:

1) Supplementary report

a) Are rates of correction being maintained?

b) Are any new backlogs developing?

c) Has dividend ever been cleared up?

d) Progress and problems in conversion.

* * * B) "Restrictions might be reimposed if your operations fall behind or progress on resolving your backlog diminishes."

5/10/68 - Firm letter. - progress report.

Error Acct - 193 items vs. 390

S.R. difs. - 259 " vs. 690

D.K. Fails - $407,390 vs. $1,917,028

Sus. Accts. - 2 out of 4 current - 1 next week.

Dividends - new systems being developed.

NS 568 A

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Retype]

01204

III.

5/10/68 - Firm letter - continued.

° Will have complete count 5/18 weekend .

° Plan full operation of 360/40 on first accounting day in June - 2 week postponed from May

May postpone to July

Current on daily data processing output.

6/28/68 - "we are still current in our record keeping

6/13/68 - Firm letter - progress report

Error Acct. - 89 vs. 193 vs. 390

S.R. diffs - $287,803 FD
304,011 FR

Sus. Accts - 3 out of four current. -

one remaining has
23 items 19,370 long
9,940 short

Divs. - further deterioration.

Random counts - and div. counts.

BEST COPY AVAILABLE

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Retype]

7/16/68 - Firm letter -

A. Error Act - 14 items left

B. S.R. diff - None has been made. - but no count planned after 7/27 conversion

C. D.K. Fails - $169,000 vs. $304,011 del
$260,000 vs. $287,803 rec

E. Sus. Accts. - 3 out of 4 -
27 items — 19,264 long / 19,516 short

F. Dividends - no substantial improvement.

8/14/68 Firm letter - SOQ - progress report

A. Error Acct. - Current

B. S.R. diff. - No complete count yet thus no know differences - cannot promise count until converted. -

C. D.K. Fails - $_____ vs. $169,000 rec.
$ 23,930 vs. 260,000 del.

E. Sus. Accts - remaining acct. - 0 long / 9,610 short

F. Dividends - continues to be problem

NS 570

PLAINTIFFS' EXHIBIT 33a IN EVIDENCE
[Retype]

01206

V.

9/16/68 Firm letter

A. Error Acct. - current

B. S.R. diff. - no complete count. Now appears unlikely that we will be able to operate ____ _____ new system for at least 2 months

C. D.K. Fails Rec. - $187,190
Del - 19,723

E. Sus. Acct. - 4 items - $7,037 short.

F. Divs. continues a problem.

10/14/68 Firm letter.

A. Error Acct. - current.

B. S.R. diff. - no complete count.- none feasible until converted - now looks like 11/30

C. D.K. fails - $ 80,496 ~~del~~ rec.
112,699 del.

E. Sus. Accts - same as last month

F. Dividends - still a problem.

NS 571

PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

E-20

11/4/67

OPERATIONS CHECK LIST
SECURITIES AND EXCHANGE COMMISSION
REGIONAL OFFICE
DATE 11/4/67

NAME OF FIRM: McDonnell & Co Incorporated SEC FILE NO. 8-8300

Classification: NYSE ASE OTC Regional Exchanges MIDWEST SECO

1. Sole Proprietorship, Partnership, Corporation.

2. No. of Partners (or Voting Shareholders) 16
No. of Registered Reps. Now 170 Six months ago 209

3. Amount of Personal Borrowings by Principals for Capital Purposes (unsubordinated)

Principal	Amount	Date of Loan	Date of Maturity	Lender
SEE LIST ATTACHED				

FIRM MAINTAINS BOOKS AND RECORDS
☐ MANUALLY
☑ MECHANICALLY
☑ ELECTRONIC DATA PROCESSING
☐ OTHER METHODS
☐ NOT KNOWN

4. Last Trial Balance and Net Capital Computation: 9/29/67
Date

Aggregate Indebtedness $11,700,000 Market Value of Proprietary Security Positions $10,997,000

Net Capital $ 7,025,000 Equity Capital $13,175,000

Ratio 166.5% Subordinated Capital 7,171,980

Does it comply with SEC Rule 15c3-1 YES or Exchange requirements (specify) EXCHANGE

If not in compliance, were there security transactions on this date N.A.

5. Date of Last SEC, SRO, or Exchange Inspection 5/15/67 NYSE 6/20/67 Overnight
Attach copy of any reports, comments, recommendations)

Agency _____ or Exchange NYSE

E-20

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PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

6. Date of last audit by Independent Public Accountant Ernst & Ernst Peat Marwick Montgomery 12/31/81

7. AVERAGE NUMBER OF DAILY TRADES DURING PAST (CUSTOMERS') BUSINESS DAYS (estimate) 3700 5 BUSINESS DAYS Six months ago 2450

" " " " " (FIRM TRADES) " " " " " 2400 " " " "

8. Estimated percentage of dollar volume by market (NYSE, Amex, Regional Exchange, OTC stocks and OTC bonds): 40% 11% 24% 225 15% Firm Trading

9. NO. OF BRANCH OFFICES: Now 25 six months ago 24

BACK OFFICE OPERATIONS PERSONNEL 455

Total Number

	SIX MONTHS AGO	NOW	FULL TIME	PART TIME	NUMBER WHO ARE REGISTERED REPRESENTATIVES	AVERAGE LENGTH OF SERVICE
Order Clerks	35	21	19	2	0	10 yrs.
P & S "	37	41	33	13	0	5 yrs.
Bookkeeping "	13	8	8	0	0	4 1/2 "
Margin "	16	69	48	11	0	1 yrs.
Dividend "	11	9	7	2	0	4 yrs.
Stock Record "	19	11	9	2	0	1 "
Transfer "	20	25	19	6	0	1 1/2 "
Cashier "	115	148	133	15	0	1 yrs.
Internal Audit "	7	4	4	0	0	1 "
Other "	314	1316	935	11	22	3 "
No. of Supervisory Personnel	63	75	75	0	8	10 yrs.
Total	603	756	643	62		

E 21

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PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

E-22

10. At What Time do Cage Personnel Complete Balancing Each Evening? 7:30 PM

Percentage of Back Office Personnel Working 1-10 Hours Overtime per Week 99%

Percentage of Back Office Personnel Working over 10 Hours Overtime per Week 2.5%

11. Number of Active Accounts: Now 57000 Six months ago 54000

Institutional	1345	400
Non-Institutional	55655	53600
Non-Institutional with standing instructions for delivery to bank vs. payment	283	325
Margin	23500	26000
Clearing Correspondents	0	0
Discretionary Accounts WITH FIRM	0	0 (NONE PERMITTED AT THIS FIRM)

12. a. Participation in Underwritings in Last 30 Days?

Issue	Amount of Participation
SEE LISTS	

b. Number of securities in which firm makes markets. Now 28 six months ago 28

13. When Was Last Physical Count and Comparison to the Stock Record Made For:

	Date	No. of Differences
Securities in Active Box	1/26/61	
All Other Securities in Physical Possession	"	1100
Detail of Open Transfer Items	"	

E-22

C12273

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PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

E-23

14. Are the Following Records Posted on a Current Basis?

(i.e. not more than two days lag)

Record	Current Yes	Current No	Latest Date Posted
Cashbook	✓		7/11/x
General Ledger	✓		
Customers Accounts	✓		
Brokers Accounts	✓		
Stock Records	✓		
Margin Records	✓		
Segregation of Customers' Free & Excess Margin Securities	✓		
Transfer Records	✓		
Securities Borrowed	✓		
Securities Loaned	✓		
Money Borrowed	✓		
Money Loaned	✓		
Fail To Receive	✓		
Fail To Deliver	✓		
Dividend Records	✓		

E-23

01274

PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

E-24

15. Suspense Accounts and Difference Accounts (estimate)

		No. of Items	Ledger Debit or Credit	Market Value Long or Short	Last Date of Zero Balance
Suspense Accounts	4/14/71	28		[illegible] SHORT	[illegible]
General Ledger Difference Accounts	4/30/71	216	[illegible] DR [illegible] CR	[illegible] LONG [illegible] SHORT	[illegible]
Dividend Account, Unclaimed (Short Stock)		15167	114,[illegible] DR [illegible] CR	[illegible] LONG [illegible] SHORT	[illegible]
Stock Record Differences	4/30/71	2659	N/A	[illegible] LONG [illegible] SHORT	[illegible]
Unsecured Accounts					
1) Customers	4/30/71	788	246,096	[illegible]	[illegible]
2) Brokers		N/A	N/A	N/A	N/A

16. Were Securities & Cash Blotters for Last 5 Business Days Balanced without the Use of Suspense or Difference Accounts?

Yes/No Yes Number of Suspense and Difference Accounts N/A

Number of Suspense and D. K. Items in the 5 Day Period (including delivery vs. payment to banks)? [illegible]

17. Are All Bank Accounts Reconciled Monthly? Yes

If not, Date All Accounts Were Last Reconciled N/A Unreconciled Difference: Debit (credit) 4/14 [illegible] 3-23-71

E-24

G1275

PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

E-25

Customers Accounts	[illegible]	[illegible]	[illegible]	[illegible]
Fail to Receive	[illegible]	0	[illegible]	[illegible]
FAIL TO DELIVER	4	0	0	0

19. Customers' Free Credit Balances 20,694,707

Non-Purpose Loans

Customers	0
Principals	1
Other	0

20. Ledger Balance of Fail to Receive and Fail to Deliver.

	(DATE)	Receive	Deliver
Current	11/1/67	27,619,369	22,266,237
Last Month	6/30	19,778,000	21,655,000
Prior Month	11/29	23,105,100	17,220,000
Six Months	12/1/67	24,189,400	21,267,900
Year	6/2/67	10,916,400	10,663,400

E-25

PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

E-26

21. Have firm prepare and submit within 5 days a summary of [illegible] to receive [illegible] age (0-30 days, 30-60 days, over 60 days) and market (NYSE, Amex, Regional Exchange, OTC stocks and OTC bonds).

22. Have firm prepare and submit within 5 days a summary of open transfer items, showing age (0-30 days, 31-60 days, over 60 days) and market (NYSE, Amex, Regional Exchange OTC stocks and OTC bonds), identifying transfer agents securities in transfer over 30 days. AS OF LAST MONTH-END SEE ATTACHED

23. Customer Complaints

A. Does firm have written procedures for processing customer complaints? YES (attach).

B. Is customer mail to registered representatives screened? By whom? NO

C. Does firm maintain a separate file for complaints received from customers? YES

D. Are notes prepared or notes maintained of customers' telephone complaints? YES

E. No. of complaints received in last three months. NONE

F. Is firm presently in litigation or arbitration with respect to any matter arising out of transactions involving delivery of securities or funds, discrepancies in accounts or any similar matter. YES

Briefly review all complaints received in last three months and obtain copies which indicate questions of serious nature. Pay particular attention to complaints which relate to the failure to receive funds or securities and account discrepancies. HAVE BEEN RECTIFIED OR IN PROCESS

24. Test 25-50 transactions to see if firm is in compliance with prompt payment requirements of Regulation "T". [illegible] NO [illegible]

E 26

PLAINTIFFS' EXHIBIT 34a IN EVIDENCE

MEMORANDUM

JUN 13 1968

TO: All Regional Administrators

FROM: The Division of Trading and Markets

SUBJECT: Back Office Problems

This supplements our memorandum of June 6, 1968. We have been informed that the NASD has also begun a program to determine the condition of their members' books and records. We attach for your information the form which is being used by the NASD.

We suggest that the inspection be coordinated with the NASD Districts to avoid duplication of effort.

In the firms which are visited after receipt of this memorandum, please obtain the following additional information and material:

(1) copies of firm's promotional literature and advertisements (List television and radio spots) for past 6 months.

(2) Total advertising and promotional expenses for past 6 months and corresponding period a year ago.

ADV- 1968- 364 284
" 1/2 1967- 319,000

PROMOT 1968- 142.000
" 1/2 1967- 45.000

NS 576

PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

01297

35a D

11/7/68

HES.

Re: McDonnell & Co. Incorporated

I am told that McDonnell & Co. has lost several V.P.'s (7-8) since the death of Sean McDonnell.

In addition, McKay is in poor health and the man they hired to relieve him has left the firm. Their operations and control is therefore said to be declining rapidly.

Please give me a report on how latest information we have looks in comparison with period in which we restricted them.

RMB

RMB

The attached summaries will show the progress (and lack of it) since April for Mc Donnell. As the firm is currently being audited, the results should help define the firm's condition when they are available. Meanwhile, the Oct MF-6 and Operations Q- due in a few days will further clarify the picture.

HES.

PLF Ex 130 adm.
D 2/12/74

Brd. 11/1/68

NS562

PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

01323

(1) 11/11/68

McDonnell + Co., Incorporated
Restrictions imposed 3/18/68 - Restrictions lifted 4/19/68

A) The firm is currently undergoing audit.

B) Conversion to IBM 360/40 - started in April with message switching and running parallel with NCR -
Planned: (1) to be completed early May
(2) completed 1st June or 1st July
(3) Weekend including July 4th
(4) by July 27th
(5) by September 3rd
(6) at least 2 more months - 11/11/68
(7) by November 30th

C) Six major areas - non-current - resolution 4/17/68 of the items - Plan: SEE ATTACHMENT "A"
(1) Error Acct. Balance - to be cleared up in [illegible]
(2) Stock Record Differences - 30 days
(3) Non Current Due Bill - 15 days
(4) Customer Accts - current
(5) Suspense Accounts - one in 32 days
one in 20 days
two in 7 days
(6) Dividends - No projected time

567

PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

01324

(2)

D) Of the six areas -

① Error Acts current by August

② S.R. diff. - none known - no count made. see footnote to Attachment "A"

③ DK Fails - differences down but not cleared up.

④ Cust. accts - reported current

⑤ Suspense Accts - down to small amount ($7,000) and 4 items - from 4 Accounts

⑥ Dividends - still a large problem - see Operations Qc summaries - question #12

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PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

01325

Attachment "A"

	4/17	5/10	6/13	7/16	8/14	9/16	10/14	
Error Acct. Balances	390	193	89	14	current	current	current	
Stock Record Differences	690	259	None Known	None Known	None Known	None Known	None Known	
Customer Accounts	Current	Current	Current	Current	current	current	current	
Suspense Accounts	4 Accounts	2 Accounts	1 Account	$19,864 short 1 Account	$9,610 short 5 items	$7,000 4 items	SAME	
Dividend Accounts	No Plan of Resolution	Continuing Problem	SAME	Hope it will	Continues to be a problem	Continues to be a problem	SAME	
Physical Counts.	Last 10/26/67 Preparing New Procedure	Planned for 5/18	No Count as Yet	After 7/27	After conversion is Complete	After conversion is complete	SAME	
DK Fails diffs.								
F. to Rec.		272,000	304,000	169,000	18[illegible],000	187,000	80,000	
F. to Del.		407,000	287,000	269,000	24,000	20,000	113,000	
Daily data processing		current	current	current	current	current	current	

"This, of course, does not mean that there may not be stock record differences as we have not yet made a complete count of all securities." "we propose to do that upon completion of conversion definitely scheduled for the weekend of July 27th."

NS 565

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PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

01226

McDonnell + Co. Operations Questionnaires

Question #	3/21	4/25	5/29	6/27	7/26	8/30	9/27
① Avg. Daily Tim.	2450	3500	3100	4,400	3,800	3,000	3,700
② Books and Records Current	Yes	Y	Y	Y	Y	Y	Y
a) Gen. Ledger	–	Y	Y	Y	Y	Y	Y
b) Cust. Accts	–	Y	Y	Y	Y	Y	Y
c) Stock Records	–	Y	Y	Y	Y	Y	Y
d) Margin Records	–	Y	Y	Y	Y	Y	Y
e) Sep.	–	Y	Y	Y	Y	Y	Y
f) D.vs.	–	Y	Y	Y	Y	Y	Y
③ Gen. Ledger in balance	Yes	Yes	Yes	Yes	Yes	Yes	Yes
date	3/20	4/25	5/27	6/27	7/26	8/30	9/27
Yes sus. diff. accts	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Bus. days not resolv.	One	One	One	One	One	One	One
④ Brothers/Sec. balanced	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Number D. K. items	–	—	—	—	—	—	—
OVER TIME details	40%	50%	45%	40%	45%	40%	50%
⑤ Int. controls							
a) Cust. Accts	1	Y-1	Y-1	Y-1	Y-1	Y-1	Y-1
b) F.R.	1	Y-1	Y-1	Y-1	Y-1	Y-1	Y-1
c) F.D.	1	Y-1	Y-1	Y-1	Y-1	(N)-1	(N)-1
d) Stocks Borrowed	1	Y-1	Y-1	Y-1	Y-1	Y-1	Y-1
e) Stocks Loaned	1	Y-1	Y-1	Y-1	Y-1	Y-1	Y-1
f) Bank Loans	E O M A	Y-1	Y-1	Y-1	Y-E M	Y-E M	Y-E M

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NS560A1

PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

01.227

	3/21	4/25	5/24	6/27	7/26	8/30	9/27
D. Obs. only							
a) Cust A.b.	—	—	—	—	—	—	—
b) F. R.	—	—	—	—	—	—	—
c) F. D	—	—	—	—	—	40,266	22,075
d) Stocks Borrow.	—	—	—	—	—	—	—
e) Stocks Loaned	—	—	—	—	—	—	—
f) Bank Loans	—	—	—	—	—	—	—
7) Date	3/18	4/25	5/29	6/27	7/26	8/30	9/27
A. I.	91,200	89,180	94,700	114,600	125,075	116,300	108,400
N. C.	6,500	6,220	7,095	6,530	7,865	8,225	7,920
Ratio	1403 to 1	1434 to 1	1335 to 1	1763 to 1	1590 to 1	1414 to 1	1369 to 1
M. V. Prop.	7,987	10,576	10,397	10,014	12,136	12,493	12,914
Net Worth	12,595	13,050	13,675	12,975	14,540	15,080	14,865
8) Cust Stk Date	2/29	4/25	5/29	6/27	7/26	8/30	9/27
Number	34,500	28,000	34,500	39,000	30,000	23,000	35,000
Correct.	Mail before	Mail before	Mail before	Mail before	Mail before	Mail before	Mail before
Complaints	614	All Rec. 330	All Rec. 300	All Rec. 225	All Rec. 200	All Rec. 200	1 247
9) Date Dif Not		Counts made for divs. - for issuing differ.	Deferred Count	Deferred Count	Deferred Count	Deferred Count.	Deferred A.S.A.P.
a) Active Box	11/21/47 1,000						
b) Passes.	11/21/47 8,000	Complete COUNT Scheduled for 6/18					
c) Trans. vs. S. R.	11/21/47 11,000						
10) Last Cash							
Fails	10/21/47	5/7/48	5/7/48	6/2/48	6/21/48	6/21/48	6/21/48
Loans Borrows	1/15/48	5/3/48	5/7/48	6/2/48	6/21/48	6/21/48	6/21/48
Banks	11/24/47	4/30/48	5/31/48	6/23/48	7/21/48	8/30/48	9/30/48

NS 58 A 1

PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

01328

	3/21	4/25	5/29	6/27	7/22	8/30	9/27					
(11) Omnibus Acts. Not Recon.	5 days	5 days	5 days	5 days	5 days	5 days	5 days					
Banks –	4/31/68	3/31	4/30	5/31	6/30	7/31	8/31					
(12) Sus Acts Items	651	269	23	27	5	4	4					
Ledger D	1,060	693	—	—	—	—	—					
Ledger C	0	125	—	—	—	—	—					
Markets L	1,766	959	20	14	—	—	—					
Markets S	614	149	10	20	10	7	7					
Diff. Acts. Items	386	382	216	189	58	124	177					
Ledger D	1,917	577	293	260	24	30	81					
Ledger C	0	372	104	170	189	187	80					
Markets L	1,908	562	257	295	27	20	154					
Markets S	0	456	267	172	192	181	119					
Div. Acts Non Current	4,918	4,812	5,167	4,417	4,417	3,582	3,567					
Ledger D	109	106	115	113	112	110	97					
Ledger C	200	201	231	165	168	166	161					
Markets L	186	191	259	293	205	197	199					
Markets S	321	194	104	190	161	265	249					
Stock Record	690	259	—	—	—	—	—					
Markets L	1,470	981	—	—	—	—	—					
Markets S	193	150	—	—	—	—	—					
Unsound Cust. Acts	321	276	228	237	190	200	184					
Ledger D	159	210	246	266	238	263	259					
Markets L	37	—	—	—	—	—	—					
Markets S	14											
(13) Producers	332	325	326	320	317	320	329					
Audit	3	3	4	5	5	5	5					
Oper. Personnel	566	574	571	625	636	605	623					
Other	331	336	349	390	406	416	432					
Total	1232	1238	1260	1340	1364	1346	1389					

NS562-A

PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

I

01329

3/18/68 – Restrictions - No. B.O. - No RRs - no plans or commitments to increase business.

4/2/68 – "We would like to have a written statement concerning:"

① The way you are organized to minimize the introduction of errors, differences, suspense items, etc. into the system and whether such items currently created are being promptly corrected;

② Details ..... for resolving non-current errors, differences, suspense items, etc., recent rate of progress in resolving each category, and a projection of when such old items would be cleared up at this rate.

4/5/68 – T.M. McDonnell – have "taken appropriate steps to reduce advertising, underwriting participations, and firm trading"

4/15/68 – You should make physical counts as reflected in Question 9 more frequently, and that your record-keeping should be good enough so that initial differences ... would be much smaller.

N563A1

PLAINTIFFS' EVIDENCE 35a IN EVIDENCE

II

01330

4/15/68 Continued — In Q 12(a) through (d) we felt that the number of items and some of the dollar figures were excessive. For a firm your size, I would like to see less than 200 items — suspense, difference, stock record — and all numbers "should be mid-six figure [illegible] at most."

4/17/68 - Letter from Sam McDonnell
Resolution of non-current items
PLAN:

A- Error Acct Balances - 390 - cleared up in 60 days
B- S.R. differences - 690 - " " " 30 days
C- Non Current & Diff fails - — " " " 18 days
D- Cust. Accts — current
E- Suspense Accts — 4 accts - one to be current - 32 days; two to be current - 9 days; One to be current - 20 days.
F- Dividends - No projected time.

4/19/68 - Planning to overcome backlogs appears adequate: — restrictions Lifted.
Supplementary Reports Required.
(1) Rates of correction being maintained ??
(2) Any new backlogs ???
(3) Dividend drive - progress to overcome
(4) Progress in conversion to 360/40

NS 5644

PLAINTIFFS' EXHIBIT 35a IN EVIDENCE

III

4/19/68 – Letter also stated "Restrictions, of course, might be reimposed if your operations fall behind or progress on resolving your backlog diminishes."

Firm currently undergoing Audit.

NS 56

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PLAINTIFFS' EXHIBIT 110
FOR IDENTIFICATION



SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
DEC 9 1968

110

Mr. Robert W. Haack
President
New York Stock Exchange
11 Wall Street
New York, New York 10005

Dear Mr. Haack:

On behalf of the Commission, I want to thank you for appearing before us on November 4 to discuss the back-office problem. We appreciate hearing your views on the current status of the problem and being brought up-to-date with respect to the various measures which have been taken. We have received John Cunningham's letter and find it most helpful.

As you know, we are deeply concerned with the present situation and believe that the present high volume and level of securities prices can only add to the problem and the potential exposure of investors and others concerned. We recognize that the Exchange has been in the forefront in adopting an impressive number of relief measures and that more time is necessary to evaluate their impact fully. However, up to now there has not been substantial improvement. Indeed, we are most concerned that conditions may be deteriorating. We know you agree with us that every effort must be made to prevent further aggravation of the various problems and to bring about their early resolution.

While the back-office problems may be operational to a large extent, and thus the responsibility of the Exchange and its members, they nevertheless raise very real questions that go beyond the efficiency of office procedures. As the brokerage community knows, a broker-dealer is chargeable with violations of applicable anti-fraud provisions if he does not have the personnel and facilities to enable him to promptly execute and consummate all of his securities transactions. Certainly, if this responsibility comes within the anti-fraud provisions, it would also fall within the Business Conduct Rules of the statutory self-regulatory authorities. According to the present level of customer complaints, a large number of your member firms may not be meeting their responsibilities under those standards. We hope, as you do, that substantial progress will be achieved in the near future, so that the Commission will not have to undertake such additional steps as are necessary to protect the interest of public investors. Among the matters which have been presented

PLAINTIFFS' EXHIBIT 110
FOR IDENTIFICATION

as having a substantial potential for improving the situation are the following measures which could be adopted promptly by the Exchange:

(1) Employment of additional examiners and other technical personnel to provide the necessary surveillance over member firms, and to render appropriate technical assistance.

(2) Imposition of all necessary restrictions to bring about immediate and substantial improvement where members are experiencing excessive levels of fails, an inability to segregate customers' securities appropriately, an inordinate number of unlocated securities differences, or difficulties in delivering securities and funds promptly to customers or otherwise in completing securities transactions.

(3) Firm application of the Exchange's net capital rules (with all applicable charges), and "buy-in" rules.

(4) Adoption of appropriate standards to evaluate members' capability to effect and consummate customers' securities transactions promptly.

(5) Assumption of an active role in the development of over-the-counter clearance facilities, including the rendering of appropriate technical and financial assistance.

We found the statistical data presented by Mr. Cunningham informative and would appreciate it if you would send us the following information on a continuing basis:

(1) Monthly fails figures of your members,

(2) Weekly fails figures for the 54 firm sample,

(3) Summaries of recommendations of the ad hoc industry advisory committee, and

(4) The names of all firms on restrictions, the nature of the restrictions, problems giving rise to the imposition of the restrictions, and a designation of those firms which you regard as being "critical" and the reasons therefor.

PLAINTIFFS' EXHIBIT 110
FOR IDENTIFICATION

We note that your Board of Governors recently indicated that the Wednesday closings would be continued through December, and that, subject to developments during December, the Exchange would discontinue the Wednesday closings in January with trading hours to be from 10:00 a.m. to 2:00 p.m. New York time. We would appreciate an explicit statement of the reasons for deciding (1) to discontinue the Wednesday closings, and (2) if five day weeks are to be resumed, for selecting the earlier closing time, particularly in light of the problems created for brokers, dealers and investors on the West Coast due to the time differential.

The Commission believes that the seriousness of present conditions requires the taking of all necessary steps to preserve the integrity of the market place and the stability of the broker-dealer community. We are sure that you see the problem in the same light.

Sincerely,

Manuel F. Cohen
Chairman

PLAINTIFFS' EXHIBIT 38 IN EVIDENCE

PLAINTIFF
EXHIBIT
U. S. Dist. Court
S. D. of N. Y.
38

01585

170

January 9, 1969

McDonnell & Company

Re: Financial Questionnaire

Talked today with Tom McKay about the firm's regular financial questionnaire as of October 31, 1968 due on January 23, 1969 on a second extension. According to McKay, the audit is completed and being pulled together and typing about to begin. The auditors have indicated that the report should be in final form Tuesday and delivered on Wednesday.

McKay was informed that we will not grant an extension for typing and; therefore, the firm would be delinquent in filing the report. I discussed the content of the report with McKay and it appears that the firm will be in violation of the capital rule after all short differences are charged to capital. He felt that the auditors were incorrectly charging some items and indicated that they have had discussions with the auditors about these items.

McKay indicated that the recently filed documents for an additional $1 million in capital and are further negotiating with an institution for more subordinate funds. McKay was informed that we will discuss their report after it has been analyzed and we will set the date shortly after the report is filed.

H. E. Schuette

HES

cc: L. Schroeder
G. H. Newman
B. Spies
P. Nalewaik

Pl. Ex 190 id.
2-11-74

Production
June 12, 1974

NS832

E-42

PLAINTIFFS' EXHIBIT 37 IN EVIDENCE

PL exh 37 ~~for ID~~
R.L. 1/25/73

January 13, 1969

McDonnell & Company

Talked today with Tom McKay concerning the audit of the firm recently completed. According to McKay, the firm needs $1.7 million to bring its ratio up to 2000% and $2.3 million to arrive at a 1500% ratio. According to McKay, $1.3 million of stock record shorts, $500,000 dividend account items and $500,000 shorts in customers' accounts have all been charged to capital.

The firm currently is raising $1.2 million in capital and is looking for other funds, especially in view of the two Partners who are leaving and taking some $400,000 with them.

McKay has been informed that upon analysis of their questionnaire he, a representative of their auditors and whoever else he feels is necessary will be requested to come to the Exchange and discuss with us our analysis of the questionnaire. McKay was informed that in the meantime the firm should make every effort to obtain additional capital so that a ratio of 1750% is possible after charging off short items with no credit for longs.

If Lybrand, Ross files the report on Wednesday, January 15 as promised, I indicated to McKay that a meeting on Monday or Tuesday of the following week was possible.

Herbert E. Schuette

HES

cc; Lou Schroeder
G. H. Newman
R. Spies
P. Nalewaik

PLAINTIFF
EXHIBIT
U. S. Dist. Court
S. D. of N. Y.
37

NS356

E-43

PLAINTIFFS' EXHIBIT 91 IN EVIDENCE

cc: Messrs. Saul, Kolton, Walker, Poser, Severn
O'Neill and Armstrong

PLAINTIFF
EXHIBIT
U. S. DIST. COURT
S. D. OF N. Y.
91

120 Broadway
New York, N.Y. 10005
Rector 2-7000

Members of
New York Stock Exchange
American Stock Exchange
and other leading
stock exchanges

January 10, 1969

Mr. H. Vernon Lee, Jr.
American Stock Exchange
86 Trinity Place
New York, New York

Dear Mr. Lee:

We are informed by our auditors, Lybrand, Ross Bros. & Montgomery, that as a result of our annual audit as of October 31, 1968, we are under capital requirements as computed in accordance with Rule 325 of the New York Stock Exchange.

This audit was completed on Monday, January 13, 1969, and a copy of the report is being sent directly to you by our auditors today, on which date it was finally available in written form.

We have already reported this fact to the New York Stock Exchange and are meeting with them next week at their convenience to discuss this matter.

We would point out that our capital ratio prior to the deduction of charges for short stock record differences, customer unsecured debits and short positions and short dividends was approximately 1500% as of the date of the audit.

Very truly yours,

McDONNELL & CO. INCORPORATED

Thomas A. McKay

Thomas A. McKay
Senior Vice President

TAM:do

PLF EXHIBIT 133
for identification
9/13, 1972
Jack Finz, Reporter

E-44

PLAINTIFFS' EXHIBIT 92 IN EVIDENCE
[Original]

92 ID

January 20, 1969

Mr. Thomas A. McKay
Senior Vice President
McDonnell & Co.
120 Broadway
New York, N. Y. 10005

Dear Mr. McKay:

This will acknowledge your letter of January 16, advising this Exchange of the capital position of your corporation, under Rule 325 of the New York Stock Exchange.

Your advising the Exchange of the situation is appreciated, and we would appreciate further your notifying the Exchange of future developments as they occur.

Sincerely yours,

HVL:pb

cc:
Messrs. Saul, Kolton, Walker,
Poser, Severud

PLF EXHIBIT 139
for identification
9/8, 1973
Jack Finz, Reporter

E-45

PLAINTIFFS' EXHIBIT 92 IN EVIDENCE
[Retype]

92 ID

January 20, 1969

Mr. Thomas A. McKay
Senior Vice President
McDonnell & Co.
120 Broadway
New York, N. Y. 10005

Dear Mr. McKay:

This will acknowledge your letter of January 16, advising this Exchange of the capital position of your corporation, under Rule 325 of the New York Stock Exchange.

Your advising the Exchange of the situation is appreciated, and we would appreciate further your notifying the Exchange of future developments as they occur.

Sincerely yours,

HVL:pb

cc:
Messrs. Saul, Kolton, Walker,
Poser, Severud

PLF EXHIBIT 139
for identification
9/18, 1973
Jack Finz, Reporter

BEST COPY AVAILABLE

E-46

PLAINTIFFS' EXHIBIT 93 IN EVIDENCE

93-P

McDonnell & Co
ESTABLISHED 1934 INCORPORATED

120 Broadway
New York, N.Y. 10005
Rector 2-7800

Members of
New York Stock Exchange
American Stock Exchange
and other leading
stock exchanges

January 21, 1969

Mr. H. Vernon Lee, Jr.
Vice President
American Stock Exchange
86 Trinity Place
New York, New York 10006

Dear Mr. Lee:

We wish to acknowledge your letter of January 20, 1969, regarding the capital position of McDonnell & Co. Incorporated.

We will notify the Exchange of any future developments regarding this matter.

Very truly yours,

McDONNELL & CO. INCORPORATED

Thomas A. McKay
Senior Vice President

TAM:do

P-F EXHIBIT 140
for identification
9/18, 1973
Jack Finz, Reporter

E-47

PLAINTIFFS' EXHIBIT 39 IN EVIDENCE
[Original]

D-01724
Px 39

January 28, 1969

McDonnell & Company

A preliminary review of the examiner's analysis of McDonnell's financial questionnaire showed the following:

Aggregate Indebtedness - $114,516,000
Required Net Capital - $5,725,000
Net Capital After Charging Short Differences - $2,869,000, capital ratio 3992%
Proprietary Position - $18,736,000
Net Capital Without Charging Short Differences - $4,215,000, capital ratio 2717%
Long Values - $9,252,000
Short Differences - $1,345,000 - charged
Net Capital Deficit - $2,856,648

It was determined that when the examiners complete their analysis and "white sheet" the report a meeting with Thomas McKay and other pertinent partners would be held with GHN to make certain additional capital was being obtained to put the firm on a sound footing.

H. E. Schuette

HES

Net Worth $11,610,000

NS828

PX 39

PLAINTIFFS' EXHIBIT 39 IN EVIDENCE
[Retype]

January 28, 1969

McDonnell & Company

A preliminary review of the examiner's analysis of McDonnell's financial questionnaire showed the following:

Aggregate Indebtedness - $114,516,000
Required Net Capital - $5,725,000
Net Capital After Charging Short Differences - $2,869,000, capital ratio 3992%
Proprietary Position - $18,736,000
Net Capital Without Charging Short Differences - $4,215,000, capital ratio 2717%
Long Values - $9,252,000
Short Differences - $1,345,000 - charged
Net Capital Deficit - $2,856,648

It was determined that when the examiners complete their analysis and "white sheet" the report a meeting with Thomas McKay and other pertinent partners would be held with GHN to make certain additional capital was being obtained to put the firm on a sound footing.

H. E. Schuette

/s/ HES

Net Worth $16,410,000

NS828

E-49

PLAINTIFFS' EXHIBIT 40 IN EVIDENCE
[Original]

40 XR

January 29, 1969

01741

Mc Donnell & Co.

Messrs. Thomas A. Mc Kay, Owen J. Jaeger and David Rowe, of Mc Donnell & Co. met today with George Beliakow, Edward Carley, Herb Schuette, Robert Spies and Peter Nalewaik, to discuss Mc Donnell & Co.'s capital position.

At the commencement of the meeting, Mr. Robert M. Bishop briefly stated that the Exchange would require that the firm's capital ratio be no greater than 2000% by the end of this week, 1,500% a week thereafter and 1,500%, deducting shorts from net capital, within one month.

Mr. Mc Kay stated that although Mc Donnell & Co. was having difficulties adhering to the Exchange's capital requirements, the firm was in no financial difficulty.

Discussion then covered discrepancies between the auditor's computation of the firm's net capital and the Exchange's computations. Various charges against capital were considered.

After resolution of the treatment of these differences and charges, it was agreed that the firm would submit amended answers to the ~~special~~ Financial Questionnaire, signed by both officers of the firm and the firm's independent accountants.

Explain

It was further agreed that the firm would obtain new capital, in order to comply with Exchange requirements as stated by Mr. Bishop, as follows:

$500,000 by 2 P.M. Friday January 31; $2,000,000 approximately one week thereafter; and either $300,000 or a corresponding reduction in $1,000,000 in outstanding shorts within one month. These figures are approximate.

Subsequently, today, the firm informed the Exchange that they would have $1,500,000 new capital by Friday, January 31, 1969, to be placed in three already existing subordinated accounts. They further informed the Exchange that they would have an additional $1,000,000 in new capital by February 20, 1969.

Peter A. Nalewaik

NS827

BEST COPY AVAILABLE

E-50

40 ID January 29, 1969

PLAINTIFFS EXHIBIT 40 IN EVIDENCE 01741
[Retype]

Mc Donnell & Co.

Messrs. Thomas A. Mc Kay, Owen W. Jaeger and David Rowe, of Mc Donnell & Co. met today with George Beliakow, Edward Carley, Herb Schuette, Robert Spies and Peter Nalewaik, to discuss Mc Donnell & Co.'s capital position.

At the commencement of the meeting, Mr. Robert M. Bishop briefly stated that the Exchange would require that the firm's capital ratio be no greater than 2000% by the end of this week, 1,500% a week thereafter and 1,500%, deducting shorts from net capital, within one month.

Mr. Mc Kay stated that although Mc Donnell & Co. was having difficulties adhering to the Exchange's capital requirements, the firm was in no financial difficulty.

Discussion then covered discrepancies between the auditor's computation of the firm's net capital and the Exchange's computations. Various charges against capital were considered.

After resolution of the treatment of these differences and charges, it was agreed that the firm would submit amended answers to the ~~Special~~ Regular Financial Questionnaire, signed by both officers of the firm and the firm's independent accountants.

It was further agreed that the firm would obtain new capital, in order to comply with Exchange requirements as stated by Mr. Bishop, as follows:

$500,000 by 3 P.M. Friday January 31; $2,083,000 approximately one week thereafter; and either $300,000 or a corresponding reduction in $1,000,000 in outstanding shorts within one month. These figures are approximate.

Subsequently, today, the firm informed the Exchange that they would have $1,500,000 new capital by Friday, January 31, 1969, to be placed in three already existing subordinated accounts. They further informed the Exchange that they would have an additional $1,000,000 in new capital by February 20, 1969.

Peter A. Nalewaik

NS 827

E-51

NYSE EXHIBIT EE(1) IN EVIDENCE

McDonnell & co
ESTABLISHED 1935 INCORPORATED

120 Broadway
New York, N.Y. 10005
Rector 2-7800

Members of
New York Stock Exchange
American Stock Exchange
and other leading
stock exchanges

March 11, 1969

New York Stock Exchange
11 Wall Street
New York, New York

Attention: Mr. Robert A. Spies
Department of Member Firms

Gentlemen:

We enclose our estimated capital position as of March 3, 1969, in accordance with our agreement to furnish you with a weekly capital computation.

While the matter of the subordinated account of Manufacturers Hanover Trust Company and Mrs. Marjorie F. McDonnell, as Trustees, is a dead issue, we continue to show the alternate computation including additional capital of $1,075,000.00 as it is our intention to replace that capital or to reduce our ration to below 1500%.

The enclosed computation does not include $600,000.00 of temporary capital deposited on March 10, 1969, in the subordinated account of T. Murray McDonnell, with the approval of Mr. Herbert Schuette, nor the receipt to date of $237,000.00 of capital from sale of additional McDonnell & Co. Incorporated stock, nor further decrease in capital penalties, nor $113,000.00 of additional capital to be realized from the sale of additional McDonnell & Co. Incorporated stock for which payment is expected momentarily.

As necessary, all of the above matters have been processed routinely with the proper persons at the New York Stock Exchange.

Very truly yours,

McDONNELL & CO. INCORPORATED

Thomas A. McKay
Senior Vice President

NYSE
EE 1 rd

TAM/mb

NYSE FXHIBIT EE(1) IN EVIDENCE

McDONNELL & CO., INCORPORATED

ESTIMATED CAPITAL POSITION (a)
MARCH 3, 1969

	(b)	(c)
Aggregate indebtedness	$120,000,000	$120,000,000
Net capital	$ 6,348,000	$ 7,423,000
Capital ratio	1,890%	1,617%
Market value of proprietory securities including $4,570,000 arbitraged positions	$ 29,351,000	$ 30,887,000
Net Worth (d)	$ 17,140,000	$ 18,676,000

(a) Does not include provision for short security differences

(b) Does not include subordinated account received February 20, 1969 with marketable security in amount of $1,536,000 with net capital value of $1,075,000.

(c) Includes subordinated account.

(d) After deducting a reserve for contingencies of $1,500,000 less taxes.

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

PX 61

3/22/69 02345

46

McDonnell & Co.

The firm's response to the regular financial questionnaire (as of 10/26/67), received by the Exchange in February, 1968, disclosed substantial figures for securities failed to receive and deliver from and to unidentified brokers, unidentified transfers and other unlocated securities differences, and error accounts. The figures had remained unresolved for long periods of time. Because of these difficulties, on March 18, 1968 the Exchange placed McDonnell & Co. on restriction.

The firm had made plans to convert from its NCR system to an IBM 360-40 sometime in May or June of 1968.

On April 2, 1968, the Exchange required a written plan for resolution of the firm's operations problems.

McDonnell's reply was received by the Exchange on April 18, 1968 outlining the firm's program for solving its operations difficulties in the following areas: Branch Offices (new order procedures to eliminate account number and type errors); Order Room and P & S departments (increase number of personnel and create trouble shooting staff, creation of trade correction group); Stock Record (four man staff to balance S/R daily); Cage (creation of "fail control group" of five men). The firm reported progress in the folliwng areas: Error account balances (40 days to clear up); Stock record differences (to be cleared up in 30 days); non-current and DK fails (net clear up of 39 items per day - to be cleared up in 18 days)' Customer Accounts (Current); Suspense Accounts (four accounts - one in 20 days); Dividends (no time projection for becoming current but seven new employees in training to assist staff). The firm requested removal of restrictions which, based on this letter, were removed on April 19, 1968. However, the firm was to report on a monthly basis, its progress in resolving old items, any new back logs that might have developed and its progress and problems in conversion.

The Exchange received the first progress report on May 10, 1968, which report showed: (1) "significant reduction in errors, differences and suspense items", (2) 50% reduction in stock record differences (3) sharp reduction in Dk fails to deliver (4) customer accounts current, (5) three of four suspense accounts current, (6) dividends still a problem. The letter further stated that the initiation of the IBM system would be delayed until June, due to late delivery of equipment. The firm reported that a complete securities count was scheduled for June 18, 1968..

NS 787

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

On June 13, 1968, the firm rendered its progress report with its SOQ, showing that: (1) Error account balances further reduced, (2) no known S/R differences, (3) further reduction in DK fails, (4) customer accounts current, (5) three of four suspense accounts current and (5) dividends still a problem. They also reported that they expected to convert to the IBM system over July 4, 1968.

One June 28, 1968 McDonnell & Co. informed the Exchange that the conversion to the IBM system would be postponed to July 27, 1968.

In a June 19, memo (HES to Lloyd McChesney) it was recommended that the firm remain on monthly reporting because of: dividend slippage, increase in fails, postponement of its scheduled full count of securities and unresolved differences in its bank accounts. Robert M. Bishop informed the firm of this by letter on June 25.

The firm reported the status of its operation again on July 16, 1968 as follows: (1) 14 open error account items, (2) no known S/R differences, (3) further reduction in DK fails, (4) customer accounts current, (5) dividends still a problem and (6) fails to deliver and receive still substantial.

On August 14, 1968, the firm reported: (1) Error Account current (~~those~~ items outstanding - to be liquidated, (2) no known S/R differences (still no full count pending conversion to IBM) (3) DK fails up (4) customer accounts current (5) still one suspense non-current (6) dividends still a problem (7) fails up again and conversion to IBM postponed until September 3.

On September 16, 1968, the firm reported that they would not be converting to the IBM system for at least two months and therefore still had not made a complete count but had no known S/R differences. They also reported: (1) DK fails up again, (2) Customer accounts current, (3) one suspense account still non-current, (4) dividends still a problem, (5) slight decline in fail.

On October 14, the firm reported that conversion to IBM would be delayed to at least November 30 and thus no securities count had been made and again no known S/R differences. Also: (1) DK fails about the same, (2) Customer accounts current, (3) one suspense account still non-current, (4) dividends still a problem and (5) fails about the same.

NYSE

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

In firm's Operations Questionnaire, HES summarized firm's operations from March 18, 1968 to October 14, 1968.

On November 15, the firm submitted its SOQ as of 10/31/68, showing no significant changes from the previous month, and reported that their surprise audit had been commenced by the branch, Ross Bros. & Montgomery as of 10/31/68.

Memo (HES - 11/4/68) discussed S/R balance - wait until audit is in.

The firms November [illegible], showed deterioration in the following areas: (1) suspense accounts, (2) differences accounts, (3) dividend accounts, (4) unsecured accounts and (5) 1,323 long and 1,221 short S/R differences discovered by auditors and unresolved at that time.

The firm requested an extension of time for filing its November SOQ, which request was denied. Nevertheless, the SOQ wasn't received until December 23.

The firm was granted an extension until December 30, 1968 for filing the regular Financial Questionnaire. This was extended until January 13, 1969.

The firm had stil not converted to IBM.

January 9, 1969 - HES memo - firm will be late in filing answers to RFQ and will probably be in capital violation as of October 31, 1968.

January 13, 1969 - HES memo- firm needs 1.7 million to meet 2000% ratio and 2.3 million to reach 1500% ratio - 1.3 million in S/R shorts, .5 million dividend charged and .5 million customer account shorts charged. Firm currently raising 1.2 million in capital.

December SOQ showed: increase in differences account; suspense and dividend about the same (but dividends substantial) and S/R differences: 9.3 million long and 1.3 million short.

In their answers to the RFQ, the firm's auditors reported the firm in Capital violation because of the following charges: $1,345,868 S/R shorts, $872,491 non-current dividends receivable and $1.049,862 deficits in customers' accounts.

NS 79

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

HES memo - January 22, 1969 - RFQ showed $7 million in fully paid securities not segregated.

HES memo - January 28, 1969 - ratio of AI to NC 3992% charging shorts, without charging shorts, ratio was 2717%.

On January 28, 1969, firm sent letter to the Exchange explaining capital problem and operation deterioration. Firm's figure showed 3.084 million needed to reach 2000% or 4.647 million needed to reach 1500%. Firm claimed operations deterioration was due to removal of [illegible] computers because of installation of IBM system and subsequent delay in converting to IBM. IBM still not operative. Firm imposed its own restrictions to reduce volume of tickets.

On January 29, 1969, firm met with Exchange staff to determine amount of capital needed. Firm agreed to file amended answers to the RFQ and obtain new capital of $500,000 by January 31, 1969, $2,083,000 (or a reduction in shorts) by end of February.

Subsequently the firm has been taking on new stockholders to raise capital.

On February 7, 1969, the Exchange sent its analysis of RFQ showing 2717% ratio.

HES memo - 2/10/69 concerning treatment of unsecured debit balances in customer cash accounts - no charge to capital.

Firm's January SOQ showed reduction in S/R differences, customers' unsecured accounts and suspense account items but difference account items were up as were non-current dividend items. The firm reported a capital ratio of 1,979%.

HES memo - February 20, 1969 - SEC had information that firm's cage was a "mess". Two Examiners at firm.

On 2/20/69 the Exchange granted the firm an extension of time to 2/27/69 for filing answers to SFQ as of 1/31/69.

On February 24, 1969, the firm responded to Exchange's letter of February 7, regardin RFQ. Capital still not below 1500%. Target date for conversion to IBM is May 1, 1969. Firm cannot assure Exchange that securities not segregated as of audit have subsequently been segregated.

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

Firm continued to raise capital, but one large contribution by a trust wasn't acceptable to the Exchange.

HES memo- March 6, 1969 - firm to get $600,000 temporary capital to cover an underwriting. However, capital could not be withdrawn if it would cause a 328 violation.

HES memo - 3/3/69 - discharged registered representative suing firm for over 1 million.

Firm continuing to raise capital - Exchange giving "rush" conditional approval for new stockholders.

On March 18, 1969 - Exchange informed firm that SFQ as of 1/31/69 shows a ratio of 2981% - therefore 328 violation again.

HES memo - 3/27/69 - HES talked to firm - it appears that firm has probably been in capital violation from 10/31/68 to 1/31/69. Problem with renewal of insurance which might again cause firm to be in violation on 4/17/69. Restrictions mentioned.

MS 791

E-58

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

McDonnell & Co., Inc.

Statistical Summary Sheet

I

FAILS TO RECEIVE AND DELIVER

	F/R	F/D	Over 30 days F/D	F/R
4/25/68	14,620,000	17,030,000	3,920,000	4,380,000
5/29/68	19,090,000	22,630,000	5,530,000	5,700,000
6/27/68	27,560,000	29,780,000	7,710,000	7,780,000
7/26/68	32,280,000	31,750,000	10,270,000	8,830,000
8/30/68	24,480,000	19,780,000	7,480,000	7,820,000
9/27/68	21,740,000	20,570,000	6,910,000	6,680,000
0/31/68	18,200,000	24,320,000	5,510,000	5,960,000
1/30/68	20,740,000	27,260,000	6,200,000	8,800,000
2/31/68	25,580,000	35,170,000	7,320,000	9,990,000
1/30/69	22,836,000	30,112,000	6,624,000	12,302,000
2/27/69	17,654,000	25,564,000	3,144,000	8,136,000

115752

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

II

STOCK RECORD DIFFERENCES

Date	#	Ld/Db	Ld/Cr	L/V	S/V
3/21/68	690			1,469,704	193,190
	(20,000 items reported as of 10/31/67 in question of 3/21/68 SOQ)				
4/25/68	259			980,999	150,290
5/29/68	None				
6/27/68	None				
7/26/68	None				
8/30/68	None				
9/27/68	None				
10/31/68	None				
11/30/68	2,544	(unresolved remaining differences as of 10/31/68 audit, no value given)			
12/31/68	2,017			9,252,538 (unresolved differences as of 10/31/68 audit)	1,345,858
1/30/69	1,627			6,943,779 (unresolved differences as of 10/31/68 audit)	895,811
2/27/69	1,503			6,791,488	778,937

KNOWN

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WS 793

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

III.

DIFFERENCE ACCOUNTS

Date	#	Ld/Db	Ld/Cr	L/V	S/V
3/21/68	386	1,917,028		1,606,382	
	(DK fails to receive not included)				
4/25/68	382	535,320	372,363	562,471	456,391
5/29/68	218	287,803	304,011	256,945	257,144
6/27/68	189	260,454	169,619	285,402	171,617
7/26/68	58	23,930	189,391	27,085	192,003
8/30/68	124	19,723	187,190	20,122	181,350
9/27/68	177	112,699	80,496	153,763	119,165
10/31/68	629	1,035,494	150,555	1,167,300	165,300
11/30/68	901	2,605,006	439,386	2,769,240	531,392
12/31/68	1,456	2,835,204	951,722	(no values given)	
1/	1,810	3,016,616	1,444,470	(no values given)	
2/27/69	250	689,869	(no values or ledger credit given)		

Firm reported on 1/30/69 SOC that it was in the process of liquidating these items. Up until that time it had reported progress in resolving these items.

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PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

IV

DIVIDEND ACCOUNTS, NON-CURRENT

Date	#	Ld/Db	Ld/Cr	L/V	S/V
3/21/68	4,918	109,023	200,143	185,615	321,199
4/25/68	4,812	105,709	201,191	180,836	194,321
5/29/68	5,167	114,615	231,204	258,593	182,225 103,7[illegible]
6/27/68	4,467	113,302	163,822	283,392	189,828
7/26/68	4,417	112,350	167,583	205,234	161,456
8/30/68	3,882	109,626	165,103	197,565	255,005
9/27/68	3,557	98,069	160,777	198,554	249,343
10/31/68	3,417	93,181	157,055	210,736	269,701
11/30/68	3,686	93,821	154,596	237,079	490,888
12/31/68	3,659	89,852	151,259	242,627	703,875
1/30/69	4,316	337,287	543,002	231,904	1,287,988
	(Long Value for 1/30/69 as reported on 2/27/69 10Q was 1,885,888)				
2/27/69	4,373	324,458	515,590	1,695,841	1,120,008

WS 79-1

PLAINTIFFS' EXHIBIT 46 IN EVIDENCE

V,

CAPITAL RATIO(%)

Date	Percentage	
3/21/68	1,403	
4/25/68	1,434	
5/29/68	1,335	
6/27/68	1,763	
7/26/68	1,590	
8/30/68	1,414	
9/27/68	1,369	
10/31/68	1,305	(Audit: Ratio after charging short differences 3092%; without charging short differences 2717%)
11/30/68	1,352	
12/31/68	1,659	
1/30/69	1,979	(Analysis of SFQ as of 1/30/69 disclosed ratio of 2981%)
2/27/69	1,890	

Analysis of 10/31/68 RFW and 1/30/69 SFQ indicates firm was probably in violation continuously from 10/31/68 to 1/30/69.

NS 7

E-63

NYSE EXHIBIT GG IN EVIDENCE
[Original]

GG 10

NEW YORK STOCK EXCHANGE
MEMORANDUM

April 9, 1969

J. CHRETTE

J. STOCK, JR.

McDonnell & Co.

Please prepare letter for my signature to McDonnell, [illegible] points I want to add to those you and Andy [illegible].

1. Details of which applications have been converted to new system.
2. Details of applications to be converted including:
   a) Target dates
   b) Present extent of programming & testing
   c) Details of conversion technique
   d) Conversion check list (if any)
   e) Alternate plan in case of delay, etc.
3. What can be done on an interim basis to improve daily operation in areas such as transfer posting.

E-64

NYSE EXHIBIT GG IN EVIDENCE
[Original]

April 10, 1969

McDONNELL & COMPANY

Work Plan to Include:

1) Reduction of short securities difference possibly semi-monthly reports.

2) Reduction of error accounts and clean up the account to make it a "true" error account.

3) Clean up of divdend shorts.

4) Clear out unidentified items in reorganization account.

5) Plans to eliminate errors in customer accounts with specific emphasis on partly secured and unsecured customer accounts.

6) Plans to strengthen supervision over margin ~~difference~~. dept.

7) Mutually agreed reporting of progress of plans.

E-65

NYSE EXHIBIT GG IN EVIDENCE
[Original]

April 11, 1969

T. Murray McDonnell
McDonnell & Co., Inc.
120 Broadway
New York, New York 10005

Gentlemen:

After reviewing our recent discussions, the various operations and financial reports from the firm and the reports of the Exchange examiners on their just completed visit, we feel it is essential that we be kept abreast of the firm's progress as it gains further control over its operations, especially during the remainder of the period of its systems conversion. To help us in this overview, we would like the firm to supply us with a practical work plan covering procedures and goals and realistic schedules for accomplishing these in the following areas:

1) A meaningful reduction in both short and long securities differences.
2) A reduction in the error account reflecting a cleaning out and elimination of those items not clearly "error."
3) A reduction in the non-current dividend shorts both money and stock.
4) The clean up of the reorganization account to eliminate the unidentified items not appropriate to the account.
5) The elimination of errors in customer accounts with emphasis on partly secured and unsecured accounts.
6) The strengthening of supervision over the margin department.

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NYSE EXHIBIT GG IN EVIDENCE
[Original]

With the implementation of a work plan, the firm should supply the Exchange with semi-monthly progress reports showing the current status of the above areas. The report should also include the results of the cycle counts and progress in the resolution of the differences.

In addition to being regularly informed on the firm's efforts to clean up some of its major records deficiencies, we of course, would like to be made more fully aware of various aspects of the 360 conversion. Please give us:

1) The details of these applications that have already been converted.
2) The details of those applications yet to be converted including:
   a. Target dates.
   b. Current status of programming and testing.
   c. Details of conversion technique.
   d. Conversion check list (if any).
   e. Alternate plan in case of delay, etc.

We would like to know what can be done on an interim basis to improve daily operations in areas, such as the transfer posting.

These are the topics that I discussed with Messrs. O'Brien, Kelley and Jaeger yesterday. The work plans are to be promptly developed and implemented. It is also important that we quickly learn the conversion details. In addition, we trust that you are continuing with your efforts to raise additional capital. Please let us know when the March Capital Computation is completed and if you have any questions on these requests.

Sincerely,

Fred J. Stock, Jr.

Fred J. Stock, Jr.
Asst. Vice President

FJS:
HM3/mt

GG ID

NYSE EXHIBIT GG IN EVIDENCE
[Retype]

N E W Y O R K S T O C K E X C H A N G E

MEMORANDUM

April 9, 1969

H. E. SCHUETTE

F. J. STOCK, JR.

McDonnell & Co.

Please prepare letter for my signature to McDonnell, there are points I want to add to those you and Andy develop.

1. Details of which applications have been converted to new system.
2. Details of applications to be converted including:
   a) Target dates
   b) Present extent of programming & testing
   c) Details of conversion technique
   d) Conversion check list (if any)
   e) Alternate plan in case of delay, etc.
3. What can be done on an interim basis to improve daily operation in areas such as transfer posting.

FJS

E-68

NYSE EXHIBIT GG IN EVIDENCE
[Retype]

April 10, 1969

McDONNELL & COMPANY

Work Plan to Include:

1) Reduction of short securities difference possibly semi-monthly reports.
2) Reduction of error accounts and clean up the account to make it a "true" error account.
3) Clean up of divdend [sic] shorts.
4) Clear out unidentified items in reorganization account.
5) Plans to eliminate errors in customer accounts with specific emphasis on partly secured and unsecured customer accounts.
6) Plans to strengthen supervision over margin ~~difference~~. dept.
7) Mutually agreed reporting of progress of plans.

E-69

NYSE EXHIBIT GG IN EVIDENCE
[Retype]

April 11, 1969

T. Murray McDonnell
McDonnell & Co., Inc.
120 Broadway
New York, New York 10005

Gentlemen:

After reviewing our recent discussions, the various operations and financial reports from the firm and the reports of the Exchange examiners on their just completed visit, we feel it is essential that we be kept abreast of the firm's progress as it gains further control over its operations, especially during the remainder of the period of its system conversion. To help us in this overview, we would like the firm to supply us with a practical work plan covering procedures and goals and realistic schedules for accomplishing these in the following areas:

1) A meaningful reduction in both short and long securities differences.
2) A reduction in the error account reflecting a cleaning out and elimination of those items not clearly "error."
3) A reduction in the non-current dividend shorts both money and stock.
4) The clean up of the reorganization account to eliminate the unidentified items not appropriate to the account.
5) The elimination of errors in customer accounts with emphasis on partly secured and unsecured accounts.
6) The strengthening of supervision over the margin department.

E-70

NYSE EXHIBIT GG IN EVIDENCE
[Retype]

With the implementation of a work plan, the firm should supply the Exchange with semi-monthly progress reports showing the current status of the above areas. The report should also include the results of the cycle counts and progress in the resolution of the differences.

In addition to being regularly informed on the firm's efforts to clean up some of its major records deficiencies, we of course, would like to be made more fully aware of various aspects of the 360 conversion. Please give us:

1) The details of those applications that have already been converted.
2) The details of those applications yet to be converted including:
   a. Target dates.
   b. Current status of programming and testing.
   c. Details of conversion technique.
   d. Conversion check list (if any).
   e. Alternate plan in case of delay, etc.

We would also like to know what can be done on an interim basis to improve daily operations in areas, such as the transfer posting.

These are the topics that I discussed with Messrs. O'Brien, McKay and Jaeger yesterday. The work plans are to be promptly developed and implemented. It is also important that we quickly learn the conversion details. In addition, we trust that you are continuing with your efforts to raise additional capital. Please let us know when the March Capital Computation is completed and if you have any questions on these requests.

Sincerely,

Fred J. Stock, Jr.

Fred J. Stock, Jr.
Asst. Vice President

FJS:
HES/mt

E-71

NYSE EXHIBIT TT IN EVIDENCE
[Oroginal]

TT TO

April 22, 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
Eleven Wall Street
New York, New York 10005

Dear Mr. Stock:

In further reply to your letter of April 11th, and pursuant to the earlier reply by Mr. J. Murray McConnell under date of April 15th. We have noted your reminder that the Exchange be kept abreast of the firm's progress in controlling operations, especially during the remainder of the period of system conversion.

We have submitted Schedule "A" attached, in reply to the six questions on page one of your letter, and Schedule "B" in reply to your questions regarding our data processing conversions on page two of your letter.

Regarding transfer posting, we have three machines and operators. Normally, the daily work has been completed by 9 a.m. Delays are occasioned by delays in securities, or transfer posting machine breakdowns. We are presently ordering an additional machine and the lead time in to an automatic margin program (can not turn to supply result action at this time. However, we will be advised by your forth comments.

We note your request that our monthly operating reports are requested, and we will, of course, comply.

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NYSE EXHIBIT TT IN EVIDENCE
[Original

02300

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms

April 22, 1960

Mr. T. Murray McDonnell will keep you advised of our success in raising additional capital.

Sincerely,

McDONNELL & CO. INCORPORATED

Thomas A. McKay
Senior Vice President

TAM:do
Enclosures

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange
11 Wall Street
New York, New York

NYSE EXHIBIT TT IN EVIDENCE
[Original]

02301

SCHEDULE "A"

1. A MEANINGFUL REDUCTION IN BOTH SHORT & LONG SECURITIES DIFFERENCES

a. Progress to date

(1) Stock record differences

	LONG	SHORT
As of 10/31/69	$22,900%	$17,447%
As of filing date of auditor's report 1/70	9,252%	1,346%
As of 4/10/70	4,073%	390%

(2) Initiation of cyclical counts commenced January 10, 1970

Securities counted to date:

Stocks (7) Letters: C,G,L,M,N,P,S

Bonds (7) Letters: C,F,G,P,U,V,T

(3) No monetary loss to date in clearing positions

b. Additional Steps:

(1) Lybrand, Ross Bros. & Montgomery will make complete count of all securities as of 4/24/70 from 4/24 - 4/27

(2) One Lybrand employee has been retained to assist in investigation and correction of indicated differences

(3) Personnel to assist in researching of differences has been increased by three outside help

2. REDUCTION IN THE ERROR ACCOUNT REFLECTING A CLEARING OUT AND ELIMINATION OF ERROR ITEMS NOT CLEARED "ERROR"

a. Situation giving rise to the "error" account:

(1) November conversion of NOR OLS to IBM 360 with the average volume of 3,200/3,200 trades per day. (Currently trades average 2,700 per day.)

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NYSE EXHIBIT TT IN EVIDENCE
[Original].

02892

(2) "Errors" relating to conversion problem totaled approximately $5,471M long and $3,221M Short on January 30th, date of initiating consolidation of accounts - deemed to be "errors" solely because of the fact they were not then currently controlled nor analyzed.

b. Steps taken to date:

(1) Accounts which were included therein are currently handled on a basis which allows for individual control (outside Cage and P & S areas) resulting in entries for adjustment and/or liquidation being made not less than 48 hours after entry into accounts.

(2) Two Lybrand employees and an internal auditor have been assigned to check and eliminate backlog.

3. A REDUCTION IN THE NON-CURRENT DIVIDEND SHORTS, BOTH MONEY AND STOCK

a. This has been recognized as a major problem area which we have not solved because of

(1) Nonavailability of skilled personnel

(2) Inability of existing personnel to keep current

b. The following steps are being taken:

(1) We are initiating immediately a program to contact by letter all managing partners of these firms indebted to us in a systematic procedure aimed at materially reducing both debit balances and security short positions

(2) The account of reauditing and updating of stock record by our auditors as of April 24th should hold in substantially resistance which give rise to incorrect dividend credits made in accounts during November - December.

(3) We are exerting every effort to augment dividend department staff to preclude increase in "non-current" items.

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NYSE EXHIBIT TT IN EVIDENCE
[Original]

C23103

SCHEDULE "A"
Page Three

(4) Progress in this area will be slow, in the circumstances above described

4. THE CATCH UP OF THE REORGANIZATION ACCOUNT TO ELIMINATE THE UNRECORDED ITEMS AND UNRECONCILED TO THE ACCOUNT

a. Steps taken:

(1) The consulting firm Leonhardt-Sullivan was retained on March 3, 1969 to retrain all employees and supply written procedures

(2) A new supervisor was hired on April 15th

b. Results obtained to date:

(1) Current work processed daily

(2) Analysis of reorganization account backlog in progress

At current rate of progress, it is expected that March 17 account balance will be completely analyzed by end of May. Inasmuch as current entries are now controlled, the account should be then be completely divested of any "non-subsequent" positions and/or entries. The account will then be analyzed each month end and required adjustments made as soon as possible after the end of the accounting month

5. THE CLASSIFICATION OF ERRORS IN CUSTOMER ACCOUNTS WITH EMPHASIS ON [illegible]

a. Analysis now being prepared to classify accounts as to reasons why the individual condition exists

b. Procedures will be formulated to contain the problem at its source. (Some customer security shorts are stock record differences rather than bona fide potential firm losses and capital charges.)

c. Restructuring of Margin Department (explained in 6 below) will allow for closer supervision of margin clerks' daily performance and assure faster recognition of those conditions which require immediate action.

NYSE EXHIBIT TT IN EVIDENCE
[Original]

SCHEDULE "A"
Page Four

6. THE STRENGTHENING OF SUPERVISION OVER THE MARGIN DEPARTMENT

The following steps have been taken:

a. We have hired a new department head, who has been in charge of a regional division of one of the largest houses in the industry, the regional division being larger than our entire operation. He appears to have proven managerial and training ability.

b. The department has been restructured to fit the most capable personnel to the complexity of the offices which they are handling

c. Supervisors have been told that their sole responsibility is supervision

d. Ten clerks are currently attending the Association of Stock Exchange Firms' margin training course, and five more will attend when the first ten complete the course.

NYSE EXHIBIT TT IN EVIDENCE
[Original]

SCHEDULE "B"

SECURE I CONVERSION

McDONNELL & CO. INCORPORATED

I. Details of Applications Already Converted

The conversion from the NCR 315 computer system to the IBM 360/40 computer system is the joint responsibility of McDonnell & Co. Incorporated personnel and Data Architects, Inc. SECURE I is the term of reference for the first phase of the conversion and is divided into three subsystems:

1. Order/Trade
2. Customer Accounting
3. Security Accounting

The applications already converted are:

Order/Trade Subsystem

This became operational March 17, 1969, and includes all trade processing from trade date through settlement date.

The Order/Trade Subsystem utilizes the IBM 360/40 computer in conjunction with a Control Data 3200 message switching computer which:

1. Edits orders to validate order sequence numbers and ticker symbols.

2. Routes messages to the proper destination in both directions.

3. Records orders and executions on magnetic journal tape. The magnetic journal tapes are routed to the IBM 360/40 computer four times each trade day and are processed as received so that immediate action can be taken to correct differences between orders and executions.

NYSE EXHIBIT TT IN EVIDENCE
[Original]

The IBM 360/40 computer system then performs the following operations:

1. Edits input for correct format and instructions.

2. Prepares errors reports for immediate correction, including:

   a. Securities which do not match the security description file.

   b. Broker names which do not match the broker name and address file.

   c. Compliance violations:

      (1) Non-marginable securities in margin accounts

      (2) Solicited orders for securities not on McDonnell's approved list

      (3) Restricted securities

3. Reports matched order/trades

   a. Maintains open order files

   b. Matches trades to open orders

Each day the IBM 360/40 runs the following programs to process transactions:

1. Security Maintenance Figuration

   This program accepts all executions, updates a file of trades which have not settled and prints:

   a. Maintenance/Figuration Report

   b. Trade Adjustment Report

2. Pre-settlement

   This program prints:

NYSE EXHIBIT TT IN EVIDENCE
[Original]

093827

a. P & S trade day blotters

b. Exception blotters (questionable trades)

c. Broker comparisons

d. Clearing House cards

e. P & S Settlement Day Blotters

3. Customer Address Maintenance Program

This program

(a) updates customer file

(b) prints customer trade confirmations

(c) prints daily listing of errors in customer names, addresses and rounding instructions for immediate correction.

In addition to the foregoing programs, the IBM 360/40 updates security description files and broker name and address files daily. Discrepancy adjustments are printed and distributed periodically for each file.

NYSE EXHIBIT TT IN EVIDENCE
[Original]

II. Details of Applications to be Converted

Details of applications to be converted are contained in following schedules:

1. Target Dates

The target date for the complete implementation of the [redacted] I is June 30th, 1969.

Target dates for completion of programs, tests and training of Mellonnell employees are shown on the following pages.

2. Current Status of Programming and Tests

The current status of programs and tests of the customer and security accounting subsystem is as follows:

All programs have been written

General documentation has been written

Tests of the programs have been conducted periodically.

3. Details of Conversion Technique

a. Objectives

Train firm personnel, utilizing reports, forms and procedures prepared by and for [redacted] I

Establish customer requirements, schedules and responsibilities for [redacted] I

Verify [redacted] I system specifications to confirm that computer programs and computer operations documentation are satisfactory

Demonstrate that all computer reports are produced on schedule and that all manual procedures are workable

NYSE EXHIBIT TT IN EVIDENCE
[Original]

Confirm that file conversion procedures are practical and valid

Supervisory Training (1 1/2 - 2 hours per session)

Supervisory training schedules follow:

DATES	FUNCTION	NO. SESSIONS
5/12 - 13	Receive & Deliver	5
	Den & Segregation	2
	Stock Record	2
	Margin	5
	Transfer	3
	Dividend	3
	Bookkeeping	1
	Reorganization	1

Clerical Training (1 1/2 hour per session)

DATES	FUNCTION	NO. SESSIONS
5/15 - 20	Receive & Deliver	5
	Den & Segregation	1
	Stock Record	2
	Margin	5
	Transfer	5
	Dividend	5
	Bookkeeping	1
	Reorganization	1

Conversion Checklist

Stock record and money balance conversion from NCR 8xx to IBM 360/40 on or before May 19 resulting in production of following reports:

(1) Customer Accounting Research Register

(2) Under/Over Segregation Report

(3) Fail to Receive Report

NYSE EXHIBIT TT IN EVIDENCE
[Original]

SCHEDULE "B"
Page Six

(4) Fail to Deliver Report

(5) Account Status Report

(6) Fail Research Report

(7) Stock Record Status Report

(8) Customer Accounting Research Report

(9) Stock Record Research Report

b. On or before May 22nd

(1) Comparison of NCR 315 and IBM one-day fails; this to be repeated as many times as necessary for different days

(2) Comparison of NCR 315 and IBM 360/40 security lists, updating the latter as required

(3) Comparison of NCR 315 and IBM 360/40 customer account lists, updating the latter where necessary

c. On or before dates shown:

(1) 5/24-25 Convert all records for the firm's general ledger accounts and five representative offices (120 Broadway, 100 Park Avenue, Chicago, Los Angeles & Beverly Hills)

(2) 5/24-25 Convert records for stocks, alphabetized as A,B & C, and all bonds under letter A

(3) 5/23 - 6/2 Collect input from 5/23 through 6/2 for the locations and securities described and process these days' transactions on a parallel basis during June

NYSE EXHIBIT TT IN EVIDENCE
[Original]

02831

SCHEDULE "B"
Page Seven

(4) Repeat preceding tests as necessary

(5) 6/21-22 Count the customer securities box

(6) 6/23-23 Update negotiable and non-negotiable positions

(7) 6/28-29 Convert these records to current status:

- Stock Record
- Transfer
- Fails
- Money Balances
- Stock Loans & Borrows
- Bank Loans
- Dividends

(8) 6/30 Complete live operation begins

5. Alternative Plan In Case of Delay

The implementation program calls for conversion tests and parallel operation tests to determine the adequacy of procedures (including forms and reports), employee training, systems specifications, computer programs and overall systems performance. When proven satisfactory, conversion will take place the following month end. The conversion is presently scheduled for the end of June 1969.

If the file conversion program is not successful by June 29, 1969, the implementation will be postponed and NCR 315 operations will continue until the next month end. The NCR 315 operation will continue to utilize the facilities of the NCR Data Center as long as necessary. The special IBM 360 computer programs written to support NCR operations will also be utilized.

In effect, this has been the technique adopted during the previous conversion of the first subsystem.

E-84

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02319

TT ID

April 22, 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
Eleven Wall Street
New York, New York 10003

Dear Mr. Stock:

In further reply to your letter of April 11th, and pursuant to the earlier reply by Mr. T. Murray McDonnell under date of April 16th, we have noted your requirement that the Exchange be kept abreast of the firm's progress in controlling operations, especially during the remainder of the period of systems conversion.

We have submitted Schedule "A" attached, in reply to the six questions on page one of your letter, and Schedule "B" in reply to your questions regarding our data processing conversions on page two of your letter.

Regarding transfer posting, we have three machines and operators. Normally, the daily work has been completed by 9 a.m. Delays are occasioned by delays in computer runs, or transfer posting machine breakdowns. The lead time in ordering an additional machine and the imminence of conversion to an automated margin program does not seem to justify additional action at this time. However, we will be guided by your further comments.

We note your request that semi-monthly progress reports are requested, and we will, of course, comply.

E-85

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02320

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms

April 22, 1969

Mr. T. Murray McDonnell will keep you advised of our success in raising additional capital.

Sincerely,

McDONNELL & CO. INCORPORATED

Thomas A. McKay
Senior Vice President

TAM:do
Enclosures

cc: Mr. G. H. Newman

Department of Member Firms
New York Stock Exchange
11 Wall Street
New York, New York

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02321

SCHEDULE "A"

1. A MEANINGFUL REDUCTION IN BOTH SHORT & LONG SECURITIES DIFFERENCES

a. Progress to date

(1) Stock record differences

	LONG	SHORT
As of 10/31/68	$22,900M	$17,447M
As of filing date of auditor's report 1/69	9,252M	1,346M
As of 4/18/69	4,873M	399M

(2) Initiation of cyclical counts commenced January 10, 1969

Securities counted to date:

Stocks (7) Letters: C,G,L,M,N,P,S

Bonds (7) Letters: C,F,G,P,U,V,T

(3) No monetary loss to date in clearing positions

b. Additional Steps:

(1) Lybrand, Ross Bros. & Montgomery will make complete count of all securities as of 4/24/69 from 4/24 - 4/27

(2) One Lybrand employee has been retained to assist in investigation and correction of indicated differences

(3) Personnel to assist in researching of differences has been increased by three outside help

2. REDUCTION IN THE ERROR ACCOUNT REFLECTING A CLEANING OUT AND ELIMINATION OF THOSE ITEMS NOT CLEARLY "ERROR"

a. Situation giving rise to the "error" account:

(1) November conversion of NCR 315 to IBM 360 with the average volumes of 3,260/3,280 trades per day. (Currently trades average 2,700 per day.)

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02322

SCHEDULE "A"
Page Two

(2) "Errors" relating to conversion problem totaled approximately $5,471M long and $3,221M Short on January 30th, date of initiating consolidation of accounts - deemed to be "errors" solely because of the fact they were not then currently controlled nor analyzed.

b. Steps taken to date:

(1) Accounts which were included therein are currently handled on a basis which allows for individual control (outside Cage and P & S areas) resulting in entries for adjustment and/or liquidation being made not more than 48 hours after entry into account.

(2) Two Lybrand employees and an internal auditor have been assigned to check and eliminate backlog.

3. A REDUCTION IN THE NON-CURRENT DIVIDEND SHORTS, BOTH MONEY AND STOCK

a. This has been recognized as a major problem area which we have not solved because of

(1) Nonavailability of skilled personnel

(2) Inability of existing personnel to keep current

b. The following steps are being taken:

(1) We are initiating immediately a program to contact by letter all managing partners of those firms indebted to us in a systematic procedure aimed at materially reducing both debit balances and security short positions

(2) The recount of securities and updating of stock record by our auditors as of April 24th should hold in correcting positions which gave rise to incorrect dividend credits made in accounts during November -- December.

(3) We are exerting every effort to augment dividend department staff to preclude increase in "non-current" items.

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02323

SCHEDULE "A"
Page Three

(4) Progress in this area will be slow, in the circumstances above described.

4. THE CLEAN UP OF THE REORGANIZATION ACCOUNT TO ELIMINATE THE UNIDENTIFIED ITEMS NOT APPROPRIATE TO THE ACCOUNT

a. Steps taken:

(1) The consulting firm Leenhardt-Sullivan was retained on March 3, 1969 to retrain all employees and supply written procedures

(2) A new supervisor was hired on April 15th

b. Results obtained to date:

(1) Current work processed daily

(2) Analysis of reorganization account backlog in progress

At current rate of progress, it is expected that March 27 account balance will be completely analyzed by end of May. Inasmuch as current entries are now controlled, the account should by then be completely divested of any "non-appropriate" positions and/or entries. The account will then be analyzed each month end and required adjustments made as soon as possible after the end of the accounting month.

5. THE ELIMINATION OF ERRORS IN CUSTOMER ACCOUNTS WITH EMPHASIS ON PARTLY SECURED AND UNSECURED ACCOUNTS

a. Analysis now being prepared to classify accounts as to reasons why the individual condition exists

b. Procedures will be formalized to contain the problem at its source. (Some customer security shorts are stock record differences rather than bona fide potential firm losses and capital charges.)

c. Restructuring of Margin Department (explained in 5 below) will allow for closer supervision of margin clerks' daily performances and assure faster recognition of those conditions which require immediate action

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02324

SCHEDULE "A"
Page Four

6. THE STRENGTHENING OF SUPERVISION OVER THE MARGIN DEPARTMENT

The following steps have been taken:

a. We have hired a new department head, who has been in charge of a regional division of one of the largest houses in the industry, the regional division being larger than our entire operation. He appears to have proven managerial and training ability.

b. The department has been restructured to fit the most capable personnel to the complexity of the offices which they are handling

c. Supervisors have been told that their sole responsibility is supervision

d. Ten clerks are currently attending the Association of Stock Exchange Firms' margin training course, and five more will attend when the first ten complete the course.

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02325

SCHEDULE "B"

SECURE I CONVERSION

McDONNELL & CO. INCORPORATED

I. Details of Applications Already Converted

The converting from the NCR 315 computer system to the IBM 360/40 computer system is the joint responsibility of McDonnell & Co. Incorporated personnel and Data Architects, Inc. SECURE I is the term of reference for the first phase of the conversion and is divided into three subsystems:

1. Order/Trade
2. Customer Accounting
3. Security Accounting

The applications already converted are:

Order/Trade Subsystem

This became operational March 17, 1969, and includes all trade processing from trade date through settlement date.

The Order/Trade Subsystem utilizes the IBM 360/40 computer in conjunction with a Control Data 8090 message switching computer which:

1. Edits orders to validate order sequence numbers and ticker symbols.

2. Routes messages to the proper destination in both directions.

3. Records orders and executions on magnetic journal tape. The magnetic journal tapes are routed to the IBM 360/40 computer four times each trade day and are processed as received so that immediate action can be taken to correct differences between orders and executions.

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02326

SCHEDULE "B"
Page Two

The IBM 360/40 computer system then performs the following operations:

1. Edits input for correct format and instructions.

2. Prepares errors reports for immediate correction, including:

   a. Securities which do not match the security description file.

   b. Broker names which do not match the broker name and address file.

   c. Compliance violations:

      (1) Non-marginable securities in margin accounts

      (2) Solicited orders for securities not on McDonnell's approved list

      (3) Restricted securities

3. Reports matched order/trades

   a. Maintains open order files

   b. Matches trades to open orders

Each day the IBM 360/40 runs the following programs to process transactions:

1. Superfile Maintenance Figuration

   This program computes all executions, updates a file of trades which have not settled and prints:

   a. Maintenance/Figuration Report

   b. Trade Adjustment Report

2. Presettlement

   This program prints:

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02327

a. P & S trade day blotters

b. Exception blotters (questionable trades)

c. Broker comparisons

d. Clearing House cards

e. P & S Settlement Day Blotters

3. Customer Address Maintenance Program

This program

(a) updates customer file

(b) prints customer trade confirmations

(c) prints daily listing of errors in customer names, addresses and standing instructions for immediate correction.

In addition to the foregoing programs, the IBM 360/40 updates security description files and broker name and address files daily. Dictionary adjustments are printed and distributed periodically for each file.

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02328

SCHEDULE "B"
Page Four

II. Details of Applications to be Converted

Details of applications to be converted are contained in following schedules:

1. Target Dates

The target date for the complete implementation of the SECURE I is June 30th, 1969.

Target dates for completion of programs, tests and training of McDonnell employees are shown on the following pages.

2. Current Status of Programming and Tests

The current status of programs and tests of the customer and security accounting subsystem is as follows:

All programs have been written

General documentation has been written

Tests of the programs have been conducted periodically.

3. Details of Conversion Technique

a. Objectives

Train firm personnel, utilizing reports, forms and procedures prepared by and for SECURE I

Establish manpower requirements, schedules and responsibilities for SECURE I

Verify SECURE I system specifications to confirm that computer programs and computer operarations documentation are satisfacto

Demonstrate that all computer reports are produced on schedule and that all manual procedures are workable

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02329

SCHEDULE "B"
Page Five

Confirm that file conversion procedures are practical and valid

b. Supervisory Training (1 1/2 - 2 hours per session)

Supervisory training schedules follow:

DATES	FUNCTION	NO. SESSIONS
5/12 -18	Receive & Deliver	5
	Box & Segregation	2 - 2,
	Stock Record	2
	Margin	5
	Transfer	3
	Dividend	3
	Bookkeeping	1
	Reorganization	1

c. Clerical Training (1 1/2 hour per session)

DATES	FUNCTION	NO. SESSIONS
5/15 - 29	Receive & Deliver	5
	Box & Segregation	1 - 2,
	Stock Record	2
	Margin	5
	Transfer	5
	Dividend	5
	Bookkeeping	1
	Reorganization	1

4. Conversion Checklist

a. Stock record and money balance conversion from NCR 315 to IBM 360/40 on or before May 19 resulting in production of following reports:

(1) Customer Accounting Research Register

(2) Under/Over Segregation Report

(3) Fail to Receive Report

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02330

SCHEDULE "B"
Page Six

(4) Fail to Deliver Report

(5) Account Status Report

(6) Fail Research Report

(7) Stock Record Status Report

(8) Customer Accounting Research Report

(9) Stock Record Research Report

b. On or before May 23rd

(1) Comparison of NCR 315 and IBM one-day fails; this to be repeated as many times as necessary for different days

(2) Comparison of NCR 315 and IBM 360/40 security lists, updating the latter as required

(3) Comparison of NCR 315 and IBM 360/40 customer account lists, updating the latter where necessary

c. On or before dates shown:

(1) 5/24-25 Convert all records for the firm's general ledger accounts and five representative offices (120 Broadway, 400 Park Avenue, Chicago, Los Angeles & Beverly Hills)

(2) 5/24-25 Convert records for stocks, alphabetized as A,B & C, and all bonds under letter A

(3) 5/26 - 6/3 Collect imput from 5/26 through 6/2 for the locations and securities described and process those days' transactions on a parallel basis during June

NYSE EXHIBIT TT IN EVIDENCE
[Retype]

02331

SCHEDULE "B"
Page Seven

(4) Repeat preceding tests as necessary

(5) 6/21-22 Count the customer securities box

(6) 6/23-26 Update negotiable and non-negotiable positions

(7) 6/28-29 Convert these records to current status:

- Stock Record
- Transfer
- Fails
- Money Balances
- Stock Loans & Borrows
- Bank Loans
- Dividends

(8) 6/30 Complete live operation begins

5. Alternative Plan In Case of Delay

The implementation program calls for conversion tests and parallel operation tests to determine the adequacy of procedures (including forms and reports), employee training, systems specifications, computer programs and overall systems performance. When proven satisfactory, conversion will take place the following month end. The conversion is presently scheduled for the end of June 1969.

If the file conversion program is not successful by June 29, 1969, the implementation will be postponed and NCR 315 operations will continue until the next month end. The NCR 315 operation will continue to utilize the facilities of the NCR Data Center as long as necessary. The special IBM 360 computer programs written to support NCR operations will also be utilized.

In effect, this has been the technique adopted during the previous conversion of the first subsystem.

E-97

PLAINTIFFS' EXHIBIT 55 IN EVIDENCE

55 GHN

MEMORANDUM

Hank, Please see what is in touch with Barton re see if they want it now into the file S

April 23, 1969

McDONNELL & CO., INC.

Late Friday afternoon Herb Schuette called and asked me to call Joe Barton of the SEC on Monday regarding McDonnell & Co., Inc.

Before calling Mr. Barton I checked with Mr. T. Murray McDonnell this morning to ask what progress has been made in introducing additional capital to the firm. Mr. McDonnell told me that today he would be borrowing $1,000,000 from the First National City Bank and, in turn, subordinating the money to the firm. Mr. McDonnell told me that documents evidencing the borrowing will be submitted to the Exchange promptly.

With this information at hand with respect to an improvement in the financial picture of the firm I called Mr. Barton who seemed particularly interested in knowing whether there was a books and records problem. I told Mr. Barton that the firm was experiencing some difficulty in this area apparently due to its conversion from NCR to IBM. I also told Mr. Barton in response to his inquiry, that the Exchange was receiving estimated capital positions from the firm and the latest one on hand was as of April 14 which showed a ratio of 1987%. Mr. Barton mentioned that he thought the Exchange was concerned when the firm exceeded a 1500% ratio and I said that it was and then told him of Mr. T. Murray McDonnell's plan to subordinate $1,000,000 today.

Mr. Barton asked when the Exchange examiners had been in the firm and I told him I did not have the exact date but I knew that the examination was finished and that the examiner's report was in the process of being finalized.

Mr. Barton mentioned that he thought he might send an SEC examiner in and I told him it was my

PLTB & 73 fr 10 7/31/73 WS 744

PLAINTIFFS' EXHIBIT 55 IN EVIDENCE

understanding that SEC examiners had been in the firm recently which he said was correct but that he understood they were only looking into Regulation T area.

G. H. Hoffman

mb

E-99

NYSE EXHIBIT 000 IN EVIDENCE

DEFENDANT'S
EXHIBIT
U. S. DIST. COURT
S. D. OF N. Y.
000

April 23, 1969

Mr. Stanley Sporkin, Director
Division of Trading & Markets
Securities and Exchange Commission
500 N. Capitol Street, N.W.
Washington, D. C. 20549

Dear Stan:

Enclosed for your information is a copy of our most recent list of firms on restriction.

This should be treated as confidential.

Sincerely yours,

Robert M. Bishop
Vice President

Enc.

mod

P.S. - In addition, McDonnell & Co. has agreed to restrict itself in lieu of Exchange restriction and we are maintaining surveillance as though they were restricted.

B

E-100

PLAINTIFFS' EXHIBIT 104 FOR IDENTIFICATION



SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
TRADING AND MARKETS

April 29, 1970

104

Mr. Robert W. Haack, President
New York Stock Exchange
Eleven Wall Street
New York, New York 10005

Dear Mr. Haack:

Attached you will find a summary of findings made by the staff of the Commission as to the application and interpretation made by the Exchange of its net capital rule (Rule 325). These findings raise grave doubts in the minds of the staff as to the retention of the present exemption to the Commission's net capital rule now enjoyed by the Exchange. As you know, this exemption was granted on the basis that the Exchange had a more comprehensive net capital rule which was stringently applied, thereby obviating the necessity of member firms' complying with the Commission's net capital rule (Rule 15c3-1).

Since the financial condition of member firms has become a source of grave concern to the Commission, we believe that immediate steps must be taken by the Board of Governors of the Exchange to rectify the improper practices which have crept into the application of the Exchange's net capital rule.

We would appreciate your bringing this matter to the attention of the Board of Governors as soon as possible and advising us within 30 days from the date of this letter as to the steps being taken by the Exchange to assure a uniform and proper interpretation and application of this rule.

I have been directed by the Commission to report to them the reaction and views of your organization along with the comments of our staff and to be prepared to make a recommendation as to whether the exemption for Exchange members should be deleted from Exchange Act Rule 15c3-1.

I do not feel it necessary to emphasize the grave importance of this matter and the urgency of the Exchange taking the appropriate measures.

Should you or any member of the staff of the Exchange have any questions concerning this, I would be happy to discuss the matter with you, and, if necessary, provide Commission staff people to assist you.

Sincerely yours,

Irving M. Pollack
Director

Attachment

PLAINTIFFS' EXHIBIT 104 FOR IDENTIFICATION

SUMMARY OF FINDINGS

The Exchange staff is interpreting and applying its net capital rule in a manner less rigorous than the Commission rule and inconsistent with the Commission's concept of liquidity in the following extremely important areas:

1. The Commission, in administering its rule, charges net worth in computing net capital with the market value of short stock record differences. The Exchange staff, on the other hand, at least since May 1969, has adopted a policy of computing net capital without a charge for short stock differences. In view of the grave nature of the industry back office problem and the grave financial exposure of a member firm with short stock differences, the failure of the Exchange to appropriately charge net worth with this item is an important shortcoming in its procedures. Very recently, the Exchange instructed its member firms that reserves established for short stock record differences must be included in aggregate indebtedness in computing a net capital position and not be included in net capital. Since the reserve which may be set up may very often be substantially less than the amount of the difference, the Exchange's new treatment is still considerably less conservative than that of the Commission. Furthermore, the danger exists that firms may be influenced by the Exchange's method either to set up insufficient reserves or fail to set up reserves at all.

2. Broker-dealers under Commission practice are required to charge net worth with clearing house deposits. The reason for this policy is the basic illiquidity of such items. Contrary to Commission practice, however, the Exchange does not charge such items to net worth as a matter of general practice.

3. The Commission haircuts commercial paper 5% in accordance with Section 15c3-1(c)(2)(C). The inspection ascertained that the Exchange applies no haircut to commercial paper. The Exchange practice thus is less comprehensive than the Commission's, and moreover appears to be in conflict with Paragraph (c)(5) of NYSE Rule 325 which reads as follows:

> (5) In the case of interest bearing obligations which do not have a conversion or exchange feature, covered by the first four ratings by any of the nationally known statistical services, the following percentages of market value shall be deducted: First rating -- 5%; second and third ratings -- 10%; fourth rating -- 15%, except that, in the case of such obligations having five years or less to maturity, covered by the first three ratings, the following percentages of market value shall be deducted: Maturity one year or less -- 1%, two years -- 2%, three years -- 3%, four years -- 4% and five years -- 5%.

BEST COPY AVAILABLE

PLAINTIFFS' EXHIBIT 104 FOR IDENTIFICATION

Our research indicates that Standard and Poors and Dun and Bradstreet rates certain commercial paper as contemplated by the above quoted paragraph and in any event it would seem that the Exchange Rule requires at the very least a 1% haircut. But even the Exchange Rule is far less comprehensive than the Commission's Rule 15c3-1. Considering the growing importance of commercial paper to a number of Exchange members, the practice of the Exchange requires immediate reconsideration. The results of our inspection also indicate that the Exchange should re-examine its practice in haircutting large blocks of stock to insure realistic charges to net worth in these cases. We assume that the Exchange will continue to enforce its policy enunciated in 1969 with respect to one firm of not giving any value for capital purposes to restricted securities.

4. Unlike the Commission, the Exchange omits to include in aggregate indebtedness bank loans received upon proprietary securities which have been sold with draft attached (but not yet cleared).

5. The Commission charges insurance claims to net worth where the insurance claim has been made but not collected because of their illiquid nature; however, the Exchange with respect to insurance claims less than 30 days old does not make such a charge.

6. Commission Rule 15c3-1 requires that a subordinated loan may not be repaid after maturity if the repayment would reduce the net capital of the broker below the required minimum. The Exchange permits subordinated loans to be repaid in such circumstances. The reason for the Commission prohibiting withdrawals in such circumstances is to protect other customers of the broker-dealer as against a lender who has expressly agreed to accept a subordinated position. Moreover, the Exchange has no express rules prohibiting withdrawal by a subordinated lender prior to maturity as does the Commission under Rule 15c3-1.

7. The Commission Rule and practice with respect to fails to receive provide that where a broker-dealer has a fail to receive of a proprietary security accompanied by a resale of such security the amount of such a fail is included in aggregate indebtedness. The Exchange Rule and practice excludes this item from aggregate indebtedness. In view of the obvious financial exposure of the member firm in this situation, the Exchange should promptly reconsider the advisability of its Rule in this regard.

8. The Commission interprets its Rule 15c3-1 as requiring a charge to net worth of good faith deposits in connection with underwritings. The Exchange in accordance with its Rule 325.15(9) treats good faith deposits as a current asset.

BEST COPY AVAILABLE

PLAINTIFFS' EXHIBIT 104 FOR IDENTIFICATION

9. The inspectors were notified that the Exchange does not require advance notice to it of withdrawal of partner's capital in the absence of resulting net capital violation. In this connection, the inspectors discovered one case of massive withdrawal of partner's capital which had not been known to the Exchange. On April 10, 1970, in connection with approval of the temporary surcharge, Chairman Budge suggested that the Exchange take action to prevent withdrawal of capital from member firms by partners by requiring its approval for such withdrawals. As a long run permanent measure we recommend consideration of a rule requiring six months advance notice before partner or shareholder capital can be withdrawn, a policy which would be consistent with Section 105 of the New York Limited Partners Act (and which should be applied to both limited partners and general partners and shareholders in view of the back office and net capital problems of the industry).

10. The Commission interprets its net capital rule as requiring commissions receivable, interest receivable on fully margined customer accounts and dividends receivable to be charged against net worth. These items are considered not readily convertible into cash. The Exchange treats such items which are less than 30 days old as good assets in computing net capital and hence applies a less rigorous standard than the Commission.

11. Commencing on October 30, 1969 the Minutes of the Board of Governors relating to net capital problems became very brief. Thereafter, with the exception of a December 18, 1969 minute (appointing a liquidator for an insolvent firm), the minutes on this subject refer only to the names of the firms on which capital reports were made and do not contain descriptions of the nature and extent of their net capital difficulties. In view of the importance of these matters, we believe that the Board of Governors should be adequately informed. Accordingly, the minutes should reflect the essentials of the reports made to the Board.

12. In addition to deficiencies in the Rule itself, as set forth above, the administration by the Exchange of the Rule has been characterized by relaxations of previous applications and interpretations or adjustments made to bring firms into purported compliance. This implementation of the Rule defeats its purpose of assuring financial liquidity and undermines the fundamental objective of the rule which is to protect investors, member firms, and others who do business with such firms.

Moreover, it should be noted that when the Exchange was originally exempted from the requirements of Rule 15c3-1 its net capital to aggregate indebtedness ratio was set by Exchange rule at 15 to 1. Since the time of that exemption the rules of the Exchange have been amended to impose the less rigorous 20 to 1 ratio. In addition Rule 15c3-1 itself has undergone substantial changes which resulted in a strengthening of its financial requirements.



E-104

NYSE EXHIBIT SS IN EVIDENCE

SS

NEW YORK STOCK EXCHANGE
AND SUBSIDIARY COMPANIES

GHN

ROUTE SLIP

TO:

- ☐ Please prepare reply for my signature.
- ☐ For appropriate action. ☐ Advise me of action taken.
- ☐ Please reply. ☐ Send me copy of reply.
- ☐ Please give me your opinion on this matter.
- ☐ Please acknowledge. ☐ No further action necessary.
- ☐ For your information. ☐ Return to me.
- ☐ For your approval. ☐ Return to _____
- ☐ For your signature. ☐ For your files.
- ☐ For discussion.
- ☐ As requested.

Mr. Kay told me S.E.C. statement closed out on 4/29.

DATE: 4/30/69 FROM: W. Thomas

☐ Completed Send to _____ ☐ Files.

10-240-7-4

E-105

NYSE EXHIBIT VV IN EVIDENCE

VV XR.

Pls ref 77 for 1
4/22/77

May 7, 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
Eleven Wall Street
New York, New York 10005

Dear Mr. Stock:

Pursuant to our agreement to furnish you with reports on a semi-monthly basis regarding control of operations and conversion to a new data processing system, we attach Schedules "A" and "B" as we did with our first report, maintaining the same paragraph and subparagraph reference numbers and letters as appeared on the original report, to facilitate comparison of current and previous reports.

We have sent this letter today because our original letter was dated April 22nd, indicating that our next report would be due fifteen days later, or May 7th. We would ask your approval, however, to make semi-monthly reports on the first and fifteenth of each month, as these dates coincide with availability of most recent information in the operations area.

After experiencing other delays in transfer posting, we have ordered a fourth transfer posting machine and are recruiting an additional operator as a precaution in the event of a conversion delay. As noted in our previous letter of April 22nd, the machine will not be delivered for four to six weeks.

Regarding raising of additional capital, you

NS 73

E-106

NYSE EXHIBIT VV IN EVIDENCE

undoubtedly have been advised by Mr. Newman that Mr. T. Murray McDonnell subordinated an additional one million dollars in his subordinated account on May 28th, 1969.

Very truly yours,

McDONNELL & CO. INCORPORATED

Thomas A. McKay
Senior Vice President

TAM:do
Enclosures

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange
11 Wall Street
New York, New York

Mr. Joseph O. Dayton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission
26 Federal Plaza
New York, New York 10007

NS731

E-107

NYSE EXHIBIT VV IN EVIDENCE

Schedule "A"

1. A MEANINGFUL REDUCTION I[illegible] SHORT & LONG DIFFERENCES

A) Progress To Date

1. Stock Record Differences:

	Long	Short
[illegible] Prior Report [illegible]/69	$4,873M	$399M
Current Status A/O 4/24/69	4,226M	368M

NOTE: No additional security counts (other than the seven (7) referred to in prior report) were conducted by Mc Donnell personnel. However, Lybrand, Ross Bros. & Montgomery conducted a complete street side count as of April 24. 1969. Recounts have been completed and this information is presently being consolidated and valued. It is expected that the results will be reportable as of May 15, 1969.

B) Additional Steps

Lybrand is committed to provide us with as many men as we require to reduce resultant stock record differences as quickly as possible. We expect to begin this adjustment program Monday, May 12.

NS732

NYSE EXHIBIT VV IN EVIDENCE

2. REDUCTION IN THE ERROR ACCOUNT REFLECTING A CLEANING OUT AND ELIMINATION OF THOSE ITEMS NOT CLEARLY "ERROR"

A) Our accounts are currently being redefined for better control and analysis. The major portion of the values which appeared in the so-called "error" account have been liquidated and/or are in process of adjustment. We have segregated fail buy-in accounts to properly define and control activity in such accounts. As previously mentioned, we have instituted procedures to allow for liquidation in these accounts no later than 48 hours after entry.

Currently the "error" account, absent fail buy-ins and related liquidations (referred to above) totaled $2,451M long and $2,792M short. The above values (based on April 24, 1969 market prices) are still being adjusted and a more accurate figure will be furnished with the May 15 report.

B) We are still employing one Lybrand man as well as our internal auditor on a full-time basis to assist in further reducing these valuations.

NS 733

NYSE EXHIBIT VV IN EVIDENCE

3. A REDUCTION IN THE NON-CURRENT ~~Unrecorded~~ SHORTS, BOTH MONEY AND STOCK

A) No major improvement can yet be reported in this area. As soon as the complete security count information is processed and available, we expect material adjustments to be made against presently reported stock dividend positions -- both long and short.

B) We are currently compiling claims by broker in order to contact the the managing partners as previously mentioned. In this connection, we will employ two (2) Lybrand personnel because our department remains understaffed.

NS 734

NYSE EXHIBIT VV IN EVIDENCE

4. THE CLEAN UP OF THE REORGANIZATION ACCOUNT TO ELIMINATE THE UNIDENTIFIED ITEMS NOT APPROPRIATE TO THE ACCOUNT

A) Our current work continues to be processed daily.

B) The analysis of the reorganization account backlog is still in progress although we are adding one Lybrand man to assure prompt completion, as well as the planned continued review of this account on a monthly basis.

NS 735

NYSE EXHIBIT VV IN EVIDENCE

5. THE ELIMINATION OF ERRORS IN CUSTOMER ACCOUNTS WITH EMPHASIS ON PARTLY SECURED AND UNSECURED ACCOUNTS

A) Customer month end equity statements were delivered to the Margin Department for analysis on May 5 and they are currently in process of examining the accounts particularly with respect to unsecured and partly secured accounts.

B) Stock record adjustments will be compared with customer accounts to ascertain whether or not stock record positions account for the reportable position.

C) Comparative figures will be available when the May 15 report is furnished.

NS 735

NYSE EXHIBIT VV IN EVIDENCE

6. THE STRENGTHENING OF SUPERVISION OVER THE MARGIN DEPARTMENT

A) Our newly hired Margin Department Manager will be on the scene May 12.

B) In conformity with the implementation of the new data processing system, we have appointed an individual whose sole responsibility is to act as liaison between the operations officer and customer accounting (Margin Department). This should further strengthen the desired supervision.

C) On the negative side, the Assistant Manager has given notice he is leaving to take a new position with another firm.

D) Our training program for clerical personnel at the ASEF is being continued as previously indicated.

NS737

E-113

NYSE EXHIBIT VV IN EVIDENCE

SCHEDULE "B"

SECURE I CONVERSION

McDONNELL & CO. INCORPORATED

I. Details of Applications Already Converted

The implementation of SECURE I's Order/Trade Subsystem using an IBM 360/40 occurred on March 17, 1969. Since then, the Subsystem has been operating successfully, but with some procedural difficulties at 120 Broadway and in the branches and some computer program bugs. To facilitate detection and correction of bugs and procedural difficulties, detailed daily performance statistics are gathered for distribution to Operations supervisors and specific individuals are assigned responsibility for corrective actions.

Problems

The major remaining problem areas are:

1. Rights Handling: An improved set of procedures is being developed in conjunction with computer program modifications.
2. Customer and Security Files: Errors resident in the old NCR files or as a result of file conversion mishaps continue to be detected and corrected.
3. Computer Operations, especially as it relates to the timing of the interfacing with the Subsystems remaining on the NCR 315. This difficulty is being attacked by a special task force.

NS 73F

NYSE EXHIBIT VV IN EVIDENCE

II. Details of Applications to be Converted

1. Target Dates

These remain as stated, including June 30, 1969 for SECURE I's complete implementation.

2. Current Status of Programming and Tests

Some of the written programs are being modified to reflect input and output format and content changes.

More detailed procedures are being drafted by McDonnell and Company supervisors aided by Data Architects Inc. (DAI), McDonnell's Systems and Procedures personnel, McDonnell's Data Management Group (DMG), and as required by Leonhardt & Sullivan people. This effort began April 28, 1969 and is scheduled to be largely completed about May 9, 1969.

Program testing is continuing as available on-site computer time permits.

3. Details of Conversion Technique

a. Objectives

These are unchanged.

b. Supervisory Training (1½-2 hours per session)

The supervisory training schedule remains the same.

N 5737

NYSE EXHIBIT VV IN EVIDENCE

c. Clerical Training (1½ hours per session)

The clerical training schedule remains the same.

4. Conversion Check list

a. The stock record and money balance conversion from NCR 315 to IBM 360/40 took place resulting in the production of the reports listed.

b. So far, but due before May 23rd:

(1) The comparison of NCR 315 and IBM one-day fails is continuing.

(2) The NCR 315 and IBM 360/40 security lists have been compared and the latter updated.

(3) The NCR 315 and IBM 360/40 customer account lists have been compared and the latter updated.

c. On or before dates for the activities described remain the same.

5. Alternative Plan in Case of Delay

Remains the same.

IHS/pmb

N5746

E-116

NYSE EXHIBIT WW IN EVIDENCE

McDonnell & co

120 Broadway
New York, N.Y. 10005
Rector 2-7800

Members of
New York Stock Exchange
American Stock Exchange
and other leading
stock exchanges

WW

RECEIVED

MAY 16 1969

G.H.N.
MEMBER FIRMS

May 15, 1969

Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange
11 Wall Street
New York, New York 10005

Dear Mr. Newman:

As requested by you today by telephone, we recapitulate herewith self-imposed restrictions under which we continue to operate until our operational condition is satisfactory, the conversion to a new data processing system is complete and our capital ratio is below 15[illegible]:

1. No new branch offices will be opened.

2. No new sales training classes will be conducted. Two classes of 30 men each, scheduled for the balance of 1969, were cancelled.

3. No compensation is paid to salesmen on buy orders of listed securities selling under $5.00 per share.

4. No compensation is paid to salesmen on purchases of listed bonds when the commission is less than $12.50 per trade.

5. No compensation is paid to salesmen on solicited day trades.

6. No new margin account will be accepted which has an equity value below $4,000 (formerly $2,000).

7. No non-purpose loan account will be accepted.

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NYSE EXHIBIT WW IN EVIDENCE

Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

May 15, 1969

8. No order for over-the-counter securities will be accepted for stocks selling under $5.00 per share unless the branch manager verifies that the order is unsolicited, the customer can accept the risk, and that the branch manager obtains a disclaimer letter from the customer certifying that the customer is aware of the firm policy to discourage speculation, that the customer has exercised his own judgment (i.e. the order was unsolicited), and that we cannot guarantee the time of delivery of the stock purchased.

9. No sell orders in over-the-counter stock will be accepted for shares selling under $5.00, unless the stock was purchased at McDonnell & Co. Incorporated, are in the client's account with us or are delivered to us in negotiable form at the time the order was placed, and the trade has a commission value of at least $6.00.

10. No buy or sell order for foreign securities subject to the interest equalization tax unless the security is listed on the New York or American Stock Exchange, the security is an American Depository Receipt, if not listed on the above Exchanges, or was previously purchased through McDonnell & Co. Incorporated. Minimum value and commission limits above cited apply to these trades.

11. Over-the-counter principal trades will be permitted only if the security is on the McDonnell approved list, or at the request of the branch manager, is approved by the Research Department.

12. Subsequent to the foregoing, by memorandum of the President, dated February 9, 1969, over-the-counter buy orders having a total value of less than $1,500, and no over-the-counter odd-lot orders, were prohibited.

E-118

NYSE EXHIBIT WW IN EVIDENCE

Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

May 15, 1969

13. We have ceased all advertising designed to attract new business.

14. We transfer and mail all new cash accounts to the customer after payment, unless the branch manager specifically approves the retention of the securities.

15. We have reduced firm trading positions to a minimum.

Sincerely,

McDONNELL & CO. INCORPORATED

Thomas A. McKay
Senior Vice President

TAM:do

cc: Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
Eleven Wall Street
New York, New York

Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission
26 Federal Plaza
New York, New York 10007

E-119

PLAINTIFFS' EXHIBIT 56a IN EVIDENCE
[Original]

P #153 for id
1/22/74 sdc
Manhattan Reporting

May 21, 1969

McDonnell & Company, Inc.
120 Broadway
New York, N. Y. 10005

Attention: Mr. T. Murray McDonnell

Gentlemen:

We are well aware of the serious operational and capital problems which your firm is experiencing and the efforts being made to resolve them. We are also aware of the self-imposed restrictions under which you will continue to operate until your operational condition is satisfactory, the conversion to a Data Processing System is complete, and your capital ratio is below 1500%. We feel, however, that until your goals are reached some additional limitations upon your business activities are necessary.

It has therefore been determined that until you are informed otherwise, the Exchange will not approve the registration of any new registered representatives or producing allied members. The number of trades handled must be limited to 12,000 per week, including underwritings. All advertisements, and sales promotion is prohibited except for that required incidental to underwritings.

To make certain that some possible inequity arising out of these restrictions can be minimized, the Exchange should be supplied with a list of registered representative trainees as well as those registered representatives not now with the firm, to whom McDonnell & Co. has a firm employment commitment. Also, we would like to have a list of branch offices currently past the planning stage but not yet opened, and a list of those advertisements presently under commitment.

In view of the capital and condition of your firm, each new capital contributor must sign a "Subordination" letter similar to the enclosed sample. Stockholders making capital renewals must also supply the Exchange with such a letter.

Sincerely,

/s/ [illegible]
Robert N. Bishop
Vice President

Enc.

RNB:FJS:FHLetman/mod

Ofr # 153?

56

BEST COPY AVAILABLE

PLAINTIFFS' EXHIBIT 56a IN EVIDENCE
[Original]

FORM OF "KNOWLEDGEABILITY" LETTER

(Date)

New York Stock Exchange
11 Wall Street
New York, New York 10005

Attention: Department of Member Firms -
Division of Finance

Gentlemen:

Accepting the suggestion of the New York Stock Exchange, I have conducted such investigation of (Name of Member Organization) and of its participants as I consider desirable, appropriate and necessary under the circumstances. Further, I have been furnished with all financial information with respect to (Name of Member Organization) as I have requested, including the latest certified audit by (Name of Auditor) dated (Date) and a recent computation of net capital prepared by (Name of Member Organization) as of (Date).

(Insert applicable description listed below*) is not being made in reliance upon the standing of (Name of Member Organization) as a member organization of the New York Stock Exchange or on the Exchange's surveillance of its capital position. I am familiar with the fact that the New York Stock Exchange has placed restrictions upon (Name of Member Organization) as set forth in its letter of (Date).

I agree that the New York Stock Exchange has no responsibility to disclose to me information concerning (Name of Member Organization) which it may now have or at any time in the future may have or to protect my interest in the member organization. I will hold harmless the New York Stock Exchange, its Special Trust Fund and each governor, officer, trustee or employee of said Exchange or Fund for any claim with respect thereto.

Very truly yours,

_____

* Insert one of the following:

My purchase of stock

or

My capital contribution

or

My subordinated loan to (Name of Member Organization) dated

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PLAINTIFFS' EXHIBIT 56a IN EVIDENCE
[Retype]

P #153 for id.
1/22/74 DC
Manhattan Reporting

May 21, 1969

McDonnell & Company, Inc.
120 Broadway
New York, N. Y. 10005

Attention: Mr. T. Murray McDonnell

Gentlemen:

We are well aware of the serious operational and capital problems which your firm is experiencing and the efforts being made to resolve them. We are also aware of the self-imposed restrictions under which you will continue to operate until your operational condition is satisfactory, the conversion to a Data Processing System is complete, and your capital ratio is below 1500%. We feel, however, that until your goals are reached some additional limitations upon your business activities are necessary.

It has therefore been determined that until you are informed otherwise, the Exchange will not approve the registration of any new registered representatives or producing allied members. The number of trades handled must be limited to 12,000 per week, including underwritings. All advertisements, and sales promotion is prohibited except for that required incidental to underwritings.

To make certain that some possible inequity arising out of these restrictions can be minimized, the Exchange should be supplied with a list of registered representative trainees as well as those registered representatives not now with the firm, to whom McDonnell & Co. has a firm employment commitment. Also, we would like to have a list of branch offices currently past the planning stage but not yet opened, and a list of these advertisements presently under commitment.

In view of the capital and condition of your firm, each new capital contributor must sign a "knowledge-

PLAINTIFFS' EXHIBIT 56a IN EVIDENCE
[Retype]

ability" letter similar to the enclosed sample. Stockholders making capital renewals must also supply the Exchange with such a letter.

Sincerely,

/s/ Robert M. Bishop

Robert M. Bishop
Vice President

Enc.

RMB:FJS:FINewman/mod

PLAINTIFFS' EXHIBIT 56a IN EVIDENCE
[Retype]

(Date)

New York Stock Exchange
11 Wall Street
New York, New York 10005

Attention: Department of Member Firms -
Division of Finance

Gentlemen:

Accepting the suggestion of the New York Stock Exchange, I have conducted such investigation of (Name of Member Organization) and of its participants as I consider desirable, appropriate and necessary under the circumstances. Further, I have been furnished with all financial information with respect to (Name of Member Organization) as I have requested, including the latest certified audit by (Name of Auditor) dated (Date) and a recent computation of net capital prepared by (Name of Member Organization) as of (Date).

(Insert applicable description listed below*) is not being made in reliance upon the standing of (Name of Member Organization) as a member organization of the New York Stock Exchange or on the Exchange's surveillance of its capital position. I am familiar with the fact that the New York Stock Exchange has placed restrictions upon (Name of Member Organization) as set forth in its letter of (Date).

---

* Insert one of the following:

My purchase of stock

or

My capital contribution

or

My subordinated loan to (Name of Member Organization) dated _____.

PLAINTIFFS' EXHIBIT 56a IN EVIDENCE
[Retype]

I agree that the New York Stock Exchange has no responsibility to disclose to me information concerning (Name of Member Organization) which it may now have or at any time in the future may have or to protect my interest in the member organization. I will hold harmless the New York Stock Exchange, its Special Trust Fund and each governor, officer, trustee or employee of said Exchange or Fund for any claim with respect thereto.

Very truly yours,

_____

E-125

NYSE EXHIBIT YY IN EVIDENCE

McDonnell&Co

120 Broadway
New York, N.Y. 10005
Rector 2-7800

Members of
New York Stock Exchange
American Stock Exchange
and other leading
stock exchanges

YY 72

June 2, 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
Eleven Wall Street
New York, New York 10005

Dear Mr. Stock:

In accordance with the established procedures regarding a semi-monthly report concerning control of operations and conversion to a new data processing system, we attach Schedules "A" and "B", maintaining the same paragraph and subparagraph reference numbers and letters as appeared on the original report to facilitate comparison of current and previous reports.

I would like to draw your special attention to Item 1 on Schedule "A" reporting the significant reduction of stock record position differences from 4,000 to a current total of 1,300.

Very truly yours,

McDONNELL & CO. INCORPORATED

Thomas A. McKay

Thomas A. McKay
Senior Vice President

Enclosures

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission

NYSE EXHIBIT YY IN EVIDENCE

SCHEDULE "A"

1. A MEANINGFUL REDUCTION IN BOTH SHORT AND LONG SECURITIES DIFFERENCES

At our specific request - and as previously mentioned - our auditors, Messrs. Lybrand Ross Bros. & Montgomery completed their securities count as of April 24, 1969, but did not release the result of such count until May 13, 1969.

The originally reported stock record position differences have been reduced from 4,000 to a current total of 1,300 . The present market valuations of those positions still open and in process of correction are $6,918 M long and $3,709 M short, both of these having been reduced from the original "raw" valuations of $23,296 M long and $16,663 M short, respectively.

Concurrently, the differences resulting from the October 31, 1968 audit are continuing to be researched and resolved and the current valuations are as follows:

LONG	-	$3,246 M
SHORT	-	203 M

NYSE EXHIBIT YY IN EVIDENCE

SCHEDULE "A"

2. REDUCTION IN THE ERROR ACCOUNT REFLECTING A CLEANING OUT AND ELIMINATION OF THOSE ITEMS NOT CLEARLY "ERROR"

Continuing the efforts previously referred to, liquidations and/or correcting journal entries were made to eliminate all long positions, not clearly "error" in nature from the reported account balances. Although some short positions remain, the reported cover value does not exceed the indicated credit balances in this account. When resulting positions are verified (upon receipt of our 5/29/69 accounting statements) during the coming week, all such positions will be liquidated and only the required adjustments of prior transactions will thereafter be processed.

In order to effect a "clean" cut-off and verification of our fail buy-in and/or liquidation accounts as of May 29, 1969, no "covering" transactions were made which would not settle as of that date. The purpose, once again, was to allow for proper verification of month-end positions and the immediate placing of all orders to uniformly clear out such positions. We would then return to the previously referred to forty-eight (48) hour program to cover all such entries.

E-128

NYSE EXHIBIT YY IN EVIDENCE

SCHEDULE "A"

3. A REDUCTION IN THE NON-CURRENT DIVIDEND SHORTS, BOTH MONEY AND STOCK

The Dividend Department has completely analyzed all short positions per its own detailed records (dividend journals) with the related stock record positions. It was the latter which were valued and used in our prior reportings to you. Appropriate stock record adjustments were made with the result that the dividend short account has been significantly reduced and more importantly [illegible] representative of those claims evidenced by the dividend department's own records. *

We are currently mailing out claim letters to all brokers in a concerted effort to eliminate all such remaining short positions.

During the coming weeks the Dividend Department will similarly compare its records with the stock record "long" (difference) positions with the similar expectation of effecting significant adjustments against our stock record "short" differences.

*This reduction has been reflected in the estimated capital positions furnished to you weekly wherein you no doubt noticed that the non-current dividend short valuations had been reduced to $562,000.

NYSE EXHIBIT YY IN EVIDENCE

SCHEDULE "A"

4. THE CLEAN UP OF THE REORGANIZATION ACCOUNT TO ELIMINATE THE UNIDENTIFIED ITEMS NOT APPROPRIATE TO THE ACCOUNT

Analysis of this account continues although not as rapidly as was first expected. The previously mentioned extra personnel remain on this assignment. We have substituted an experienced (outside) employee for the Lybrand man who had to be withdrawn due to other commitments. The target date now for completion of the analysis is June 13th, rather than May 29th, as was originally suggested.

BEST COPY AVAILABLE

NYSE EXHIBIT YY IN EVIDENCE

SCHEDULE "A"

5. THE ELIMINATION OF ERRORS IN CUSTOMER ACCOUNTS WITH EMPHASIS ON PARTLY SECURED AND UNSECURED ACCOUNTS

Continued effort is being directed by the Margin Department in its program to reduce the unsecured debits and customer shorts. The current obligations to review and analyze reports, as well as train supervisory and clerical personnel, with respect to the proposed implementation of SECURE, has unfortunately preempted much of the department's time which ordinarily would have been devoted to work on above program.

Whereas, the following table shows continued progress in reducing both unsecured debits and customer shorts, it was necessary to have a complete customer statement (and equity) run rescheduled for the end of May so that proper concentration could be given to properly analyzing the partly secured accounts. When the results are available, you will be so notified.

The comparative results for the two (2) most recent periods are as follows:

	5/29/69 (000)	5/15/69 (000)
Unsecured debits	$ 247	$ 266
Customer shorts	288	412

The continuous correction of our stock record is being significantly reflected in the reduction of customer shorts.

BEST COPY AVAILABLE

NYSE EXHIBIT YY IN EVIDENCE

SCHEDULE "A"

6. THE STRENGTHENING OF SUPERVISION OVER THE MARGIN DEPARTMENT

As previously mentioned, Mr. Paul LoBiondo officially assumed his responsibility as Manager of the Credit (Margin) Department on May 12, 1969. He continues to exhibit those supervisory qualities which we expected he could bring to this position and we feel confident that future reports will confirm such expectation.

NYSE EXHIBIT YY IN EVIDENCE

SCHEDULE "B"

SECURE I CONVERSION

McDONNELL & CO. INCORPORATED

I. Details of Applications Already Converted

No change since our last report.

II. Details of Applications to be Converted

1. Target Dates

Although to recognize that there have been delays in the implementation of the details of conversion, SECURE I's complete implementation remains scheduled for June 30, 1969, and other target dates remain as stated, except as noted below.

2. Current Status of Programming and Tests

The previously noted additional programs are being specified and are expected to be written and tested before June 20, 1969 in one instance and before June 27, 1969 in the remaining cases, rather than all before June 20, 1969 as previously stated.

Detailed procedures continue to be drafted and are scheduled to be largely completed about June 9, 1969 rather than May 23, 1969, as previously stated.

Program testing is continuing using on-site and outside equipments.

NYSE EXHIBIT YY IN EVIDENCE

3. Details of Conversion Techniques

a. Objectives

These are unchanged.

b. Supervisory Training (1½ - 2 hours per session)

The supervisory training schedule dates have been extended again, to 6/9, rather than 5/12 - 5/16 as originally scheduled.

c. Clerical Training (1½ hours per session)

The clerical training schedule dates are extended again to 6/9 - 6/13, rather than 5/15 - 5/29 as originally scheduled.

4. Conversion Checklist

a. Stock record and money balance conversion and production of reports completed as previously reported.

b. The NCR 315 and IBM 360/40 comparisons required before May 23rd completed as reported previously.

c. On or before dates shown:

(1) 5/24 - 25 becomes 5/31 - 6/6 for conversion of all records for selected accounts and representative offices.

NYSE EXHIBIT YY IN EVIDENCE

(2) 5/24 - 25 becomes 5/31 - 6/6 for conversion of records for selected stocks and bonds.

(3) 6/2 - 8 for collection of selected data and parallel processing cancelled in favor of use of similar data collected at the end of April.

5. Alternative Plan in Case of Delay

As before

E-135

NYSE EXHIBIT ZZ IN EVIDENCE

RECEIVED

JUN 17 1969

G.H.N.
MEMBER FIRMS

ZZ

June 16, 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
Eleven Wall Street
New York, New York 10005

Dear Mr. Stock:

In accordance with the established procedures, I am enclosing our semi-monthly report concerning control of operations -- Schedule A.

Concerning Schedule B, the conversion to a new data processing system, we have been advised by Data Architects, Inc. that DAI will be unable to meet the target date of June 30 for complete implementation of SECURE.

Mr. Henry C. B. Lindh, who will join us as Senior Vice President of Operations on July 1, has an appointment with you at 4 PM on Wednesday to discuss the re-evaluation and re-scheduling of the implementation of the final two subsystems of SECURE. Therefore, we are not enclosing a Schedule B with this report.

Very truly yours,

McDONNELL & CO. INCORPORATED

Lawrence F. O'Brien
President

Enclosure

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission

NS 6816

NYSE EXHIBIT ZZ IN EVIDENCE

SCHEDULE "A"

1. A MEANINGFUL REDUCTION IN BOTH SHORT AND LONG SECURITIES DIFFERENCES

Efforts are continuing in reducing long and short securities differences, both with respect to the October 31, 1968 audit differences as well as the April 24, 1969 special securities count conducted by our auditors.

The following valuations do not reflect additional adjustments off setting positions in the reorganization account. The latter account analysis was completed (6/13/69) as of the close of business May 29, 1969 and the necessary journal entries are currently being processed through the various accounts. When completed, a new valuation run will be prepared and the adjusted long and short positions should indicate appreciable reductions.

Absent the above adjustments, the following represents the most current valuations i.e., as of 6/13/69:

	Audit October 31, 1968	Special Count April 24, 1969
Long valuations	$ 2,827 M	$ 2,685
Short valuations	$ 192 M	$ 1,417

As per discussions held with representatives of the N.Y.S.E. on June 6, 1969 it was indicated by Mr. Bishop that a certain period of time - not defined - would be allowed before considering capital charges with respect to the April 24th count. In connection therewith, it is our intention to make in-house counts on the remaining open items to determine their validity and, based on such results, take steps to adjust or otherwise liquidate the positions.

NS687

E-137

NYSE EXHIBIT ZZ IN EVIDENCE

SCHEDULE "A"

2. REDUCTION IN THE ERROR ACCOUNT REFLECTING A CLEANING OUT AND ELIMINATION OF THOSE ITEMS NOT CLEARLY "ERROR"

At the present time, a final review is being made to assure liquidation of positions remaining open as of May 29, 1969. Although all orders were entered, the related executions have not been received. We have now obtained all pending orders from our traders to check against the position balances and expect that these will be reentered within the next few days.

NS 688

NYSE EXHIBIT ZZ IN EVIDENCE

SCHEDULE "A"

3. A REDUCTION IN THE NON-CURRENT DIVIDEND SHORTS, BOTH MONEY AND STOCK

As mentioned previously, claim letters were prepared for mailing to brokers. This program has now been completed and responses are being received. At this particular time, it is not possible to assess the results to any great degree inasmuch as less than 20% in responses have been received to date.

NS 685

NYSE EXHIBIT ZZ IN EVIDENCE

SCHEDULE "A"

4. THE CLEAN UP OF THE REORGANIZATION ACCOUNT TO ELIMINATE THE UNIDENTIFIED ITEMS NOT APPROPRIATE TO THE ACCOUNT

Analysis of the reorganization account was completed on Friday, June 13th as of the close of our previous accounting month May 29, 1969.

Journal entries are currently being processed as a result of this analysis. Liquidations are also being entered to cover non-valid positions in the account.

Whereas, the May 29, 1969 account indicated long and short valuations of $1,762 M and $2,908 respectively, the adjusted balances will read $138 M long and $60 M short.

From information available, it would appear that the bulk of the adjustments will be made against the stock record difference accounts and customer positions.

This account will be analyzed each month by the head of our Reorganization Department and such analysis will be retained in the department's files.

W569c

NYSE EXHIBIT ZZ IN EVIDENCE

SCHEDULE "A"

5. THE ELIMINATION OF ERRORS IN CUSTOMER ACCOUNTS WITH EMPHASIS ON PARTLY SECURED AND UNSECURED ACCOUNTS

Due to certain delays occasioned by computer down-time, the equity runs were not available until today (June 16th). These will be reviewed as soon as practicable and the results reported. However, all the statements for May 29, 1969 were run and checked out by the Margin clerks. Mr. LoBiondo, Manager of the Department, is currently reviewing same with his supervisors.

The information presented below represents an update of the prior month's indicated differences:

	June 13, 1969 (000)	May 29, 1969 (000)
Unsecured debits	$ 242	$ 247
Customer shorts	267	288

NS691

E-141

NYSE EXHIBIT ZZ IN EVIDENCE

SCHEDULE "A"

6. THE STRENGTHENING OF SUPERVISION OVER THE MARGIN DEPARTMENT

At the present time, seven (7) of our employees are taking the advanced margin training course and five are currently attending the ASDF training school for basic margining instruction.

Additionally, we have begun an in-house training program on a moderate scale. The sessions run 1 hour a day and are conducted by section supervisors each morning prior to the commencement of the day's work. We expect to broaden this program in the near future.

NS 692

E-142

NYSE EXHIBIT AAA IN EVIDENCE

McDonnell & Co.

Please call for it 4/30/73

SOJ

AAA TD

120 Broadway
New York, N.Y. 10005
Rector 2-7200

Members of
New York Stock Exchange
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and other leading
stock exchanges

July 1, 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
4 New York Plaza - 21st Floor
At Broad & Water Streets
New York, New York 10004

Dear Mr. Stock:

In accordance with the established procedures, I am enclosing our semi-monthly report concerning control of operations - Schedule A.

Concerning Schedule B, the conversion to a new data processing system, we are in the final process of determining the future course of the system following the failure of Data Architects, Inc. to meet the June 30 target date for complete implementation.

As we discussed when I met with you on June 18, I will submit to you a copy of an alternate proposal for converting the remaining parts of our back office operations. I expect to have a firm proposal within the next two weeks.

Very truly yours,

McDONNELL & CO. INCORPORATED

Henry C. B. Smith
Senior Vice President

Enclosure

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission

NYS 625

NYSE EXHIBIT AAA IN EVIDENCE

SCHEDULE "A"

1. A MEANINGFUL REDUCTION IN BOTH SHORT AND LONG SECURITIES DIFFERENCES

As of the close of our June accounting period, June 26, 1969, the following represents the remaining security positions open on our records:-

	6/26/69 (000)	6/13/69 (000)
Audit 10/31/68:		
Long valuations	$ 252	$ 2,827
Short valuations	$ 16	$ 192
Special Count 4/24/69:		
Long valuations	$1,565	$ 2,685
Short valuations	$ 799	$ 1,417

Efforts are continuing in our endeavors to reduce and/or completely eliminate these positions in the coming weeks. We continue to employ two (2) Lybrand auditors to assist our own team of five (5) persons engaged in this project.

NYSE EXHIBIT AAA IN EVIDENCE

SCHEDULE "A"

2. REDUCTION IN THE ERROR ACCOUNT REFLECTING A CLEANING OUT AND ELIMINATION OF THOSE ITEMS NOT CLEARED "ERROR"

As previously reported, we continue to significantly reduce positions in our so-called "error" account. According to projections made on a trade date basis for this month end (6/26/69) - tabulation runs are not yet available - the long valuation in this account should approximate $ 500 M and the short valuation, $ 300 M. In this connection, I refer you to our original report, dated 4/22/69, wherein it was noted that as of January 30, 1969 the respective amounts were $5,471 M and $3,221 M.

Although the valuations are being reduced continuously, additional analysis will be required in this account before it can be effectively considered as "resolved".

N5 677

NYSE EXHIBIT AAA IN EVIDENCE

SCHEDULE "A"

3. A REDUCTION IN THE NON-CURRENT DIVIDEND SHORTS, BOTH MONEY AND STOCK

The Dividend area continues to remain a major source of concern. Whereas, it was believed that real progress had been achieved, last months results - when finalized - tended to disprove that fact.

The May 29th month end capital calculation showed an increase of some $ 580 M over previously reported figures. Of this increase, $ 296 M was due to an erroneous computation of stock record adjustments which purportedly affected the dividend short account. Another $ 165 M represented an increase in "shorts" due primarily to redemption of due bills. I have been informed that practically all of this will be offset when our own due bills are honored. The remaining balance of $ 119 M represents the uncollected portion of the prior month's "current" dividend claims which since became "aged" in our computations.

We lost an assistant section head in this department and remain understaffed by three (3) individuals. Leonhardt-Sullivan, our outside consultants, are currently working within this department in an effort to provide us with assistance for the immediate as well as the future problems.

N567

NYSE EXHIBIT AAA IN EVIDENCE

SCHEDULE "A"

4. THE CLEAN UP OF THE REORGANIZATION ACCOUNT TO ELIMINATE THE UNIDENTIFIED ITEMS NOT APPROPRIATE TO THE ACCOUNT

The preparation of journal adjustments required to bring this account into a truly current status continues. It would appear that the original results of the June 13, 1969 analysis are holding. I understand your Mr. Andrew McElroy has been reviewing our progress in this account.

No month end valuation figures are yet available but will be provided with next report.

N5675

NYSE EXHIBIT AAA IN EVIDENCE

SCHEDULE "A"

5. THE ELIMINATION OF ERRORS IN CUSTOMER ACCOUNTS WITH EMPHASIS ON MARTLY SECURED AND UNSECURED ACCOUNTS

As previously mentioned the May 29, 1969 equity runs were not made available to our Margin Department until June 16, 1969 and although extensive work has been performed with respect to reviewing the accounts, this job has not been completed as yet. It is expected that the results will be provided with the July 15, 1969 report.

For your information, the balances as per last report are shown:

	June 13, 1969 (000)	May 29, 1969 (000)
Unsecured Debits	$ 242	$ 247
Unsecured Shorts	$ 267	$ 288

NS68c

NYSE EXHIBIT AAA IN EVIDENCE

SCHEDULE "A"

6. THE STRENGTHENING OF SUPERVISION OVER THE MARGIN DEPARTMENT

The five (5) employees, previously referred to have completed their course in basic margin instruction.

We are continuing an in-house training program and hope within a relatively short period of time to expand this on a more formal basis.

At the present time, we are negotiating with a senior clerk as well as a supervisor - in our continuing efforts to upgrade this department.

NS681

E-149

NYSE EXHIBIT BBB IN EVIDENCE

McDonnell & Co.

BBB

120 Broadway
New York, N.Y. 10005
Rector 2-7800

Members of
New York Stock Exchange
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stock exchanges

July 15, 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
4 New York Plaza - 21st Floor
At Broad & Water Streets
New York, New York 10004

Dear Mr. Stock:

In accordance with the established procedures, I am enclosing our semi-monthly report concerning control of operations, Schedule A, and the conversion to a new data processing system, Schedule B.

Schedule B and the attachments outline the alternate plan we have decided to adopt for converting the remaining parts of our back-office operations. You will note that Automatic Computer Services, Inc. has confirmed its ability to accomplish the conversion on August 30, 1969. We at McDonnell intend to take all the steps necessary so that this conversion date can be met.

Very truly yours,

McDONNELL & CO. INCORPORATED

Henry C. B. Lindh
Senior Vice President

Enclosure

E-150

NYSE EXHIBIT BBB IN EVIDENCE

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange
4 New York Plaza - 21st Floor
At Broad & Water Streets
New York, New York 10004

Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission
26 Federal Plaza
New York, New York

RECEIVED
JUL 16 1969
G. H. N.
MEMBER FIRMS

NYSE EXHIBIT BBB IN EVIDENCE

SCHEDULE "A"

1. A MEANINGFUL REDUCTION IN BOTH SHORT AND LONG SECURITIES DIFFERENCES

Researching has been completed with respect to the October 31, 1968 audit differences and with the exception of two security positions, all others have been adjusted, transferred and/or liquidated. (These two positions are now being adjusted).

The remaining open stock record differences appearing on our records and still being researched are those resulting from the special count we had made as of April 24, 1969. The comparative results for the two most recent reporting dates are as follows:

	7/11/69 (000)	6/26/69 (000)
Long valuations	$ 1,463 X	$ 2,635 X
Short valuations	603 X	1,417 X

The valuations reported above are based on April 24, 1969 market prices and have not been adjusted to reflect the current market decline. Remaining open positions have now been individually key punched and future reporting will be made to reflect current market valuations.

We continue to employ two Lybrand auditors to assist in our program to eliminate these stock record differences.

NYSE EXHIBIT BBB IN EVIDENCE

SCHEDULE "A"

2. REDUCTION IN THE ERROR ACCOUNT REFLECTING A CLEARING OUT AND ELIMINATION OF [illegible] "ERROR"

The tabulated valuations reported as of 6/26/69 were $ 713 M long and $ 370 M short, both of which were slightly higher than anticipated in our prior reporting.

After applying known adjustments the current amounts are $ 448 M long and $ 260 M short and orders are being entered to cover and/or liquidate these positions.

There are, of course, other positions which, under our pricing procedures, have not been valued. Our continuing review and researching indicates, however, that no substantial adjustment would be made to the above reported amounts.

NYSE EXHIBIT BBB IN EVIDENCE

SCHEDULE "A"

3. A REDUCTION IN THE NON-CUR T DIVIDEND SHORTS, BOTH MONEY AND STOCK

Unfortunately, progress remains slow in the Dividend area and the results have been disappointing to date. This month-end showed a decline of approximately $ 200 M over the prior reporting, but still leaves a hard core of approximately $ 500 M which covers outstanding claims for 1967 and 1968.

Leonhardt-Sullivan, our outside consultants, are still working in this area and we have obtained a full-time experienced clerk (through an outside agency) to assist in researching the older claims.

NYSE EXHIBIT BBB IN EVIDENCE

SCHEDULE "A"

4. THE CLEAN UP OF THE REORGANIZATION ACCOUNT TO ELIMINATE THE UNIDENTIFIED ITEMS NOT APPROPRIATE TO THE ACCOUNT

Unlike the Dividend Department progress of a substantial nature continues to be made in this account. The reported position as of June 26, 1969 showed a debit balance of $ 177 X with security valuations of $ 1362 X long and $ 2125 X short.

Inasmuch as this account is undergoing continuing research, review and adjustment the figures should not be considered as being final nor indicative of potential loss.

The most recent figures as of Friday, July 11, 1969 have been reported as follows:

Long valuations	$ 1262 X ✓
Short valuations	$ 1231 X ✓
Debit balance	$ 154 X ✓

NYSE EXHIBIT BBB IN EVIDENCE

SCHEDULE "A"

5. THE ELIMINATION OF ERRORS IN CUSTOMER ACCOUNTS WITH EMPHASIS ON PARTLY SECURED AND UNSECURED ACCOUNTS

The May 29th equity runs, which as previously mentioned were received on June 16, 1969, have been the subject of concerted review to date. To reflect the information as clearly as possible, the following table is presented to compare the information as previously reported with the results as evidenced by the May 29, 1969 analysis.

BALANCES AS OF

	MARCH 31, 1969			
	Prior Report	Current Status	Additional April & May Items	Present Total
Unsecured Shorts	$ 267 M	$ 213 M	$ 151 M	$ 364 M
Unsecured Debits	$ 242 M	$ 223 M	$ 49 M	$ 272 M

The above presentation is not necessarily complete inasmuch as the April and May additions are not yet finalized. The amounts as shown represent the facts as of this present reporting but it is expected that where the analysis has been completed these will be further reduced. We have undertaken to forward to our branch offices the details underlying the above tabulation requesting that they, in turn, apprise us as to any errors. The responses should aid in resolving any erroneous positions now being reported.

NYSE EXHIBIT BBB IN EVIDENCE

SCHEDULE "A"

6. THE STRENGTHENING OF SUPERVISION OVER THE MARGIN DEPARTMENT

Training of our margin clerks is continuing, both at the ASEF sessions and in-house.

We have employed a senior clerk and as previously reported, are still negotiating with a supervisory clerk to strengthen the [illegible] this department.

NYSE EXHIBIT BBB IN EVIDENCE

SCHEDULE "B"

McDONNELL & CO. INCORPORATED

DATA PROCESSING CONVERSION

As set forth in our report of July 1, we are pleased to submit to you copies of letters from Automatic Computer Services (ACS) and Peat Marwick Mitchell & Co. (PMM). The ACS letter sets forth a proposed automation schedule and the PMM letter of July 14 comments on the feasibility of this program. The PMM letter of July 11 describes their support effort to be made available in this conversion.

The decision to implement the ACS system and suspend further work on "SECURE" was made in recognition of ACS's proven past performance record and the urgent requirement that the books and records of McDonnell be kept on a more timely basis. The McDonnell organization has been informed of this change in policy and all employees have indicated their willingness and desire to abide by the tight timetable necessary to insure success in this conversion. It is recognized by all concerned that the mere fact of conversion to a proven system will not cure the problems but it is the hope of management that with up to date daily and weekly reports, the operating departments of McDonnell will be able to resolve and eliminate the conditions causing capital penalties in the computation of the AI ratio.

Attachments: ACS letter July 11, 1969
PMM letter July 11, 1969
PMM letter July 14, 1969

E-158

63-H

03675

PLAINTIFFS' EXHIBIT 63 IN EVIDENCE

August 27, 1969

MEMORANDUM

McDonnell & Co. was discussed at the coordinators meeting this morning.

Harry Lindh had reported that the conversion to ACS was progressing satisfactorily. This morning they were in the process of converting P & S and it was going better than expected. Stock Record would begin late today or early tomorrow and entire system will be converted sometime during the weekend. Lindh indicated that the conversion would faciliatate the delivery of accounts out and thus make the sale of branches easier.

Three offices had been sold to Bache and they had closed the Doylestown, Pa. branch and were about to close Philadelphia. Negotiations were underway for the sale of a New Jersey branch to Harris, Upham. The Chicago branches had been consolidated as had the New York City offices.

Lindh indicated that at this time the capital ratio was about 1770% using the tax refund as good capital.

PHF

E-159

NYSE EXHIBIT SSS IN EVIDENCE

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
REGIONAL OFFICE
26 FEDERAL PLAZA
NEW YORK, N.Y. 10007

IN REPLYING PLEASE QUOTE
NY-E (NC)
NYSE
SSS

August 28, 1969

Mr. P. Fitzgerald
Department of Member Firms
New York Stock Exchange
Four New York Plaza - 21st Floor
At Broad & Water Streets
New York, New York 10004

Dear Mr. Fitzgerald:

Mr. Marc Epstein, an attorney on our staff, has requested that you furnish him with copies of memoranda and correspondence that he has examined in your office pertaining to McDonnell & Co.

Your cooperation in this matter is appreciated.

Very truly yours,

KEVIN THOMAS DUFFY
Regional Administrator

By: Michael L. Blane
Michael L. Blane
Chief Attorney

DEFENDANT'S
EXHIBIT

E-160

TTT for id

NYSE EXHIBIT TTT IN EVIDENCE

August 28, 1969

Mr. Marc Epstein
Securities & Exchange Commission
26 Federal Plaza
New York, New York

Dear Mr. Epstein:

Enclosed please find documents relating to McDonnell & Company requested in your letter of August 28, 1969.

Very truly yours,

Paul H. Fitzgerald
Assistant Coordinator

Enc.
PHFitzgerald:mat

NYSE EXHIBIT CCC IN EVIDENCE

CHN

McDonnell & co

120 Broadway
New York, N.Y. 10005
Rector 2-7800

Members of
New York Stock Exchange
American Stock Exchange
and other leading
stock exchanges

CCC TD

September 4, 1969

SEP 5 1969

Mr. Fred J. Stock, Jr.
Assistant Vice President
Department of Member Firms
New York Stock Exchange
4 New York Plaza - 21st Floor
At Broad & Water Streets
New York, New York 10004

Dear Mr. Stock:

In accordance with the established procedures, we enclose our semi-monthly report concerning control of operations, Schedule A, and the conversion to a new data processing system, Schedule B.

Very truly yours,

McDONNELL & CO. INCORPORATED

Henry C. B. Lindh
Senior Vice President

Enclosures

cc: Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission
26 Federal Plaza
New York, New York

NYSE EXHIBIT CCC IN EVIDENCE

EXHIBIT A

No significant changes have taken place in accounts being reconciled as reported in previous Exhibit A. This temporary halt was occasioned by the conversion of all accounts to a revised data processing system. Accelerated reconciliation efforts are now in process.

NYSE EXHIBIT CCC IN EVIDENCE

EXHIBIT B

The conversions of all accounts in the firm of McDonnell & Co. Incorporated have been effectively implemented. On August 22, the P & S processing was converted to the ACS method of handling. Over the week-end of August 29/September 1 all other accounts in the firm were converted to the ACS data processing system. Stock records and trial balances were proofed prior to and subsequent to conversions and all details in both records were individually proofread to insure complete and accurate transfer. All margin accounts and cash accounts were printed in detail and available in the Margin Department prior to the opening of business on September 2. These accounts are now in the process of being compared to the TF records and SMA record balances are being carried forward where applicable. No report can be made with respect to daily work as the system is in its initial start-up phases. Current indications are that data processing is considerably more accurate than has been experienced in the past as well as being completely up to date. Further details concerning the conversion will be provided in the next report.

NYSE EXHIBIT DDD IN EVIDENCE

DDD

S22 S

October 29, 1969

McDONNELL & COMPANY, INC.

Messrs. T. Murray McDonnell and Paul McDonald met with Messrs. Bishop, Stock and Newman this afternoon.

Mr. Paul McDonald reported that the stockholders had approved the recapitalization plan on October 27th.

He then reviewed the past recent history of the firm mentioning that it had been practically cut in half in August and that with a loss of $1,500,000 in September and possibly the loss of another $1,000,000 in October, he wanted to report on the future of the firm. He mentioned that the revenues had not increased and he cannot forsee an increase in them in the near future; that merger talks were not in the cards, partly because of business conditions, and secondly because the larger firms really did not need McDonnell and smaller firms could not take them on and that, above all, people were just afraid of possible contingent liabilities.

The decision has been made to boil the firm down into a New York City Company. The 400 Park Avenue office hopefully will become strong in the retail end, and the 120 Broadway office strong in institutional business. Probably, the decision will be to keep the Paris office. This is the decision that the McDonnell family has made that will take the firm into the future. Mr. McDonald stated that according to the firm's calculations the net worth is about $9,300,000 and he assured us that capital requirements are being made; the ratio at the moment being 1,550%.

It is expected that agreement will be entered into to sell five branches; Boston, Chicago, Detroit, Denver and Century City to Shearson Hammill & Co., Inc.. It is expected that before the day is over the San Francisco office will be sold to another firm. Mr. McDonnell did not mention the name of this firm.

NYSE EXHIBIT DDD IN EVIDENCE

He stated that according to Shearson Hammill & Co., Inc., and the other firm, the accounts of these offices could be taken over in a matter of weeks but he was not sure that McDonnell could deliver them that soon. Mr. McDonald assured us that there was no thought at all of closing the business.

Mr. T. Murray McDonnell then mentioned that he was happy to announce that Paul McDonald had accepted the [illegible]nt and Chief Executive Officer.

Copy of telegram to Paul McDonald dated 3:10 PM 10/29/07. Sent to this and other firms.

G.H.N.

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PLAINTIFFS' EXHIBIT 111 IN EVIDENCE

111

October 30, 1969

The Honorable Hamer H. Budge
Chairman
Securities and Exchange Commission
500 North Capitol Street, N.W.
Washington, D.C. 20549

Dear Chairman Budge:

You will recall that at our meeting before the Commission on October 24 you were promised written summaries regarding the firms of Amott, Baker; McDonnell & Co. and White & Co. Enclosed are memoranda on Amott, Baker & Co. and McDonnell & Co. which describe the problem, the cause of the problem, the current status of the firm, and the program for resolving the firms' problems. The memorandum on White & Co. will be sent to you tomorrow.

We trust that these summaries will answer your questions regarding these specific firms and will demonstrate the control which the Exchange has on these situations. We firmly believe that the present course of action in each of these situations is the one that is most in the interest of the firms' customers as well as providing a rapid solution to the problem.

Should you have questions on these summaries, please do not hesitate to contact us.

Sincerely yours,

(Signed) R. John Cunningham

Enc.

cc: Donald L. Calvin
RJCunningham/FJStock:jt

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PLAINTIFFS' EXHIBIT 111 IN EVIDENCE

McDONNELL & COMPANY, INC.

Basic Problem

Declining volume and substantial expenses from a new computer system which did not work caused operating losses which resulted in capital violation.

Background

The daily trading volume of the firm rose from about 900 trades a day two years ago to about 3,500 trades a day in mid-1968. In an effort to handle the increased volume, the corporation in 1967 retained the firm of Data Architects, Inc. as consultants to design a complete system for processing securities transactions from the inception of the order to the delivery of the security.

The proposed new system required more sophisticated hardware and in April, 1968 an IBM 360-40 data processing computer was installed. The installation of the IBM 360-40 required the planned removal of one of the two NCR 315 computers which was being utilized. From April 1968, until the middle of 1969, the corporation was processing its entire computer output on one-half of the equipment previously available, as the IBM 360-40 was devoted entirely to testing of the new system.

PLAINTIFFS' EXHIBIT 111 IN EVIDENCE

During 1968, the corporation incurred additional expenses of some $1,000,000 incidential to the undertaking of conversion to the system, with resultant impact on earnings and hence on capital.

The target dates for conversion to the new system which was to be accomplished in three steps were moved back from April 1968 and it was not until March 17, 1969 that the first stage of the new system, after several very unsuccessful attempts, became operational.

The firm was restricted by the Exchange in March and April 1968 and again in February 1969. Bookkeeping errors at these times had created needs for additional capital which was added by the firm. In August 1969, however, the firm was unable to raise sufficient additional capital to replace its operation losses and determined to sell 18 offices as well as two seats on the New York Stock Exchange and one on the American Stock Exchange.

Paul McDonald, an executive with experience in reorganisation of troubled businesses, was appointed Agent of the Corporation to conduct the business of the corporation. He instituted a drastic program of cost reduction which together with sharply reduced aggregate indebtedness and liquidation of firm and subordinated positions appeared to keep the firm in capital compliance in September.

PLAINTIFFS' EXHIBIT 111 IN EVIDENCE

The firm equity was depleted to the point of not meeting Exchange requirements. Consequently, stockholders representing over 51% of the ownership and $8,800,000 of subordinated accounts agreed to a reorganization in which sufficient subordinated loans are being converted into equity to restore the firm to compliance.

In Mid-June 1969, the corporation was advised by Data Architects, Inc. that it would be unable to meet the new target date of June 30 for complete implementation of the first phase of the conversion.

In retrospect it is apparent that the death of the firm's Executive Vice President in mid 1968 and the illness and subsequent death in 1969 of its Operations Vice President created a serious lack in decision making at the firm.

On July 15, 1969, the corporation notified the Exchange that it had decided to adopt an alternate plan to convert its back-office operations utilizing the facilities of Automatic Computer Services, Inc.. Successful conversion to the Automatic Computer Services, Inc., was made over the Labor Day 1969 weekend. An Exchange examiner visiting the corporation on October 8-10, 1969 reported that the books and records were being maintained on a current basis.

PLAINTIFFS' EXHIBIT 111 IN EVIDENCE

On September 16, 1969, the corporation submitted a projection which was based on a reasonably active stock market which showed an operations loss for August of $1,158,000, an estimated loss in September of $715,000 and a projected loss in October of $230,000.

While the corporation had anticipated that the loss for September would approximate $725,000, it has been reported that the actual September loss was approximately $1,500,000. The increase in the loss over that estimated is largely represented by the fact that the commission income decreased $432,000 between August and September and that the corporation was obliged to rescind trades in Roto-American stock approximating $175,000.

The delivery of assets of the sold branch offices continues. The corporation presently has nine remaining branch offices.

The sale of the McDonnell Fund, Inc. to Scheinman, Hochstin & Trotta, Inc. for a price of $650,000 is slated for December 12, 1969 subject to the approval of the fund's shareholders.

Since February 1969, the corporation has furnished the Exchange with weekly estimated capital computations and, beginning in April, with semi-monthly reports concerning control operations and the conversion to a Data Processing System. The corporation has submitted copies of these reports to Mr.

PLAINTIFFS' EXHIBIT 111 IN EVIDENCE

Joseph O. Barton, Chief of Broker-Dealer Inspection, Securities & Exchange Commission, 26 Federal Plaza, New York, New York.

These reports have shown that progress is being made in:

1) Resolving short and long securities differences (of approximately 4,000 differences discovered by a special count as of April 24, 1969 only five short positions remain as of October 15th. Subsequent cycle counts have disclosed fewer differences with each report.)
2) A reduction of the "errors" account reflecting a cleaning out and elimination of these items not clearly "error" ("errors" valued at $5,471,000 long and $3,221,000 short as of January 30, 1969 have been reduced to $596,000 long and $234,000 short as of October 15, 1969).
3) The clean-up of the reorganization account to eliminate items not appropriate to this account (outstanding items from prior to August 28, 1969 have been reduced to long valuations of $326,000, short valuations of $442,000 and leger credit balance of $19,000).
4. The elimination of errors in customers' accounts with emphasis on partly secured and non-secured accounts (as of October 15, 1969 the customer account remaining balances were unsecured shorts of 244,000 and unsecured debits of 37,000).
5. The strengthening of supervision over the Margin Department (ACS conversion has provided some up-to-date reports which assist in exercising controls in this department. The relatively smooth conversion to ACS has enabled the firm to maintain its record keeping system with its own personnel on a daily basis and has also enabled them to reassign the work force to problem areas.

PLAINTIFFS' EXHIBIT 111 IN EVIDENCE

The reports also indicate that slow progress had been made in the area of non-current dividends.

If the plan program does not result in elimination of substantial losses by November and continued capital compliance, the Exchange will consider further sales of branch offices to further reduce aggregate indebtedness.

The firm reported on October 29, 1969, that they have re-estimated their loss for October to be $1,000,000 and that revenues have not increased and it does not appear that they will in the near future. As a result the firm has decided to consolidate into a New York City firm possibly retaining their Paris branch office. The one New York office would be primarily involved in retail business and the other in institutional. The remaining offices will be sold, five of them possibly to Shearson Hammill & Co., Inc., and the other one to another member firm. They indicated that the transfer of these accounts could probably be effected in a matter of weeks if McDonnell can deliver them that soon. They assured us that there was no thought of closing the business, with the firm's net worth of about $9,300,000 and with capital requirements being met (current ratio 1,550%).

Mr. T. Murray McDonnell advised that Paul McDonald had accepted the position of President and Chief Executive Officer of the firm.

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NYSE EXHIBIT HHH IN EVIDENCE

HHH-17

November 12, 1969

Mr. Robert A. Spies
Department of Member Firms
New York Stock Exchange
4 New York Plaza - 21st Floor
at Broad & Water Streets
New York, New York 10004

Dear Mr. Spies:

In accordance with our agreement to furnish you with a weekly capital computation, we enclose our estimated capital position as of November 7th, 1969.

Very truly yours,

McDONNELL & CO., INCORPORATED

Henry C.B. Lindh
Senior Vice President

HCBL:bf

enclosures

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission

bcc: T. Murray McDonnell
Paul K. McDonald
Ira Kapenstein
Owen W. Jaeger
David W. Rome

NYSE EXHIBIT HHH IN EVIDENCE

McDONNELL & CO., INCORPORATED

ESTIMATED CAPITAL POSITION

NOVEMBER 7, 1969

Aggregate Indebtedness	$61,310,000
Net Capital (1)	$3,695,000
Capital Ratio (1)	1,659%
Market Value of Proprietory Securities	$9,700,000
Net Worth	$8,730,000

NOTE:

(1) After deducting the following computed as of August 28, 1969:

Market value non-current short dividend positions - 100%	$1,044,000
Market value short security differences - 30%	-
	$1,044,000

Before deducting above:

Net Capital	$4,739,000
Capital Ratio	1,294%

NYSE EXHIBIT HHH IN EVIDENCE

McDONNELL & CO., INCORPORATED

AGGREGATE INDEBTEDNESS

	November 7 1969	October 31 1969	Increase (Decrease)
Money Borrowed - Customers	$30,100,000	$30,200,000	$ (100,000)
Securities Loaned - Customers	3,760,000	4,310,000	(550,000)
Securities Failed to Receive - Customers	4,450,000	2,950,000	1,500,000
Customers Free Credit Balance	7,620,000	7,620,000	-0-
Customers other Credit Balances	13,300,000	13,300,000	-0-
Other Liabilities	2,080,000	2,080,000	-0-
	$61,310,000	$60,460,000	$ 850,000

NYSE EXHIBIT HHH IN EVIDENCE

McDONNELL & CO., INCORPORATED

NET CAPITAL
(Under Rule 325 NYSE)

Estimate October 31, 1969	$3,710,000
Deduct:	
Increase in penalties on firm accounts	15,000
Estimate November 7, 1969	$3,695,000

NYSE EXHIBIT HHH IN EVIDENCE

McDONNELL & CO., INCORPORATED

PROPRIETORY SECURITIES

NOVEMBER 7, 1969

	Estimated Market Value
Securities borrowed under subordination agreements	$3,270,000
Securities owned by firm:	
Arbitraged positions	345,000
Municipal bonds deposited with clearing organizations	273,000
Corporate bond trading positions	1,387,000
Other trading and underwriting positions	368,000
Error positions (principally fail buy-ins etc.)	3,177,000
	$5,550,000
Securities not readily marketable (Investment account)	880,000
	$9,700,000

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

December 11'69 - 2:30 - Commission Room
SEC - Washington, D. C.

109 ID

Present:

Commissioners - Budge, Owens, Smith, Needham and Herlong

NYSE - Haack, Cunningham, Bishop, Calvin

SEC staff - Pollack, Barr, Sporkin, Rappaport, Loomis, Finn, L. Bloch

and others.

Chairman Budge - Please give a rough evaluation of solvency of the firms on the Street.

And an analysis of Hayden, Stone and Dempsey-Tegeler and any other problem firms.

Cunningham - About eight firms in capital violation or near 1500% . Some firms are critical.

Chairman Budge - What do you mean by critical?

Cunningham - (Discusses Amott, Baker)

Commissioner Owens - Understood going to contribute $10,000,000 to that firm.

Cunningham - No, that was Gregory & Co.
(continues discussing Amott, Baker)

Chairman Budge - Do you think your reporting procedures are adequate when firms get in trouble? Do you think the early warning system is doing the job?

Cunningham - (Discusses what is being done)

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Haack - Some members having been giving selves credit for restricted stock. Bringing this to the attention of members.

Chairman Budge - Still would like an appraisal of "do we have something to worry about here."

Cunningham - (Discusses situation)

Chairman Budge - We are having trouble getting a good evaluation of whether there is something to worry about.

Chairman Budge - I gather that if there is something that the Commission should be doing that you will tell us.

Cunningham - Yes, sir.

Chairman Budge - Let's move on then.

Cunningham - I will recap the 5 - 6 firms that have problems and then move into other firms.

Chairman Budge - Start with Dempsey Tegeler and Hayden, Stone.

Cunningham - (Discusses these two firms)

Chairman Budge - What is Dempsey Tegeler's capital ratio?

Bishop - Might need $3 - 5 million before they get to 2000 percent.

Chairman Budge - If $6 million loan not forthcoming do you plan to do something?

Cunningham - (Made good progress thus far in five weeks)

Bishop - If down to 2000 percent in January and continue to deliver out accounts, clearing records, etc. will probably bring them to 1500% in say six weeks.

Commissioner Smith - Does this firm have the management to continue to be a viable firm? Is a man from Haskens and Sells running the firm?

Commissioner Needham - Question about Dempsey Tegeler. Did you say they are not liquidating securities in their sub-ordinated accounts?

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Bishop - No, they have not (explains why)

Commissioner Needham - Certainly something you would require them to do if necessary?

Bishop - correct

Commissioner Needham - Understand Dempsey Tegeler has about $600,000 in stolen securities that they received from Hayden, Stone.

Bishop - I don't know that

Commissioner Needham - I have a feeling that don't understand the stolen securities problem and I would like to come back to it at some later meeting.

Commissioner Smith - Is this subordinated securities account locked in?

Commissioner Needham - How is it that I know that Dempsey Tegeler has $600,000 in stolen securities and you don't know it. Who on the staff knows?

Staff - Both Dempsey and Hayden Stone have told us.

Cunningham - (Discusses lost and stolen securities claims)

Cunningham - They could probably raise the money($650,000) if they were not on restriction with the SEC.

Chairman Budge - We told them, if they could raise the money, that we would remove the restriction.

Commissioner Needham - I would like to ask the staff.

Kevin Duffy* - They asked for a specific capital figure - I told that if we disallowed all "ify" items it would be $6 million. But asked them to come up with their figure.

Our restrictions would be set out in a letter and lender would have to sign the letter.

Commissioner Needham - You're telling me that Hayden Stone not willing to disclose financial position to the lender.

* SEC Regional Administrator in New York

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Commissioner Smith - I don't understand the problem - if raise the capital will be off restriction?

Kevin - Question of how much capital that must be raised - about $4-1/2 million.

Commissioner Needham - Can't understand why Hayden, Stone confused. Commissions position is clear. Has NYSE and NY regional office of SEC sat down to discuss this?

Kevin - Not recently.

Commissioner Needham - Wonder if removing restriction is a bargaining tool for raising a certain amount of capital. Are we saying might do it if raise $5 million?

Kevin - No we are being quite specific.

Chairman Budge - Do rules of Exchange permit counting tax claims, etc? Or are you waiving your rules?

Cunningham - No (Discussion)

Chairman Budge - At what point do you give 30 days credit for insurance claims?

Cunningham - Received letter from Pollack today.

Commissioner Needham - Did you receive that letter today? If I had known if your letter was here I would not have mailed the other letter.

Commissioner Needham - Getting little confused. Like to clarify - the treatment affording Hayden Stone - Do you expect that member firms be allowed this type of capital treatment in the future?

Cunningham - (Discusses insurance claims)

Commissioner Needham - Staff informed me that if we have a broker-dealer in net capital violation we close the firm immediately. What are you learning by this experience?

Commissioner Needham - If situation repeats itself, the Commission could expect a work out rather than a close down.

Cunningham - Yes

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Commissioner Smith - Well maybe a Pickard

Commissioner Owens - Or a merger situation

Chairman Budge - That troubles me. We have an obligation to see that our rules are enforced and some obligation to see that your rules are enforced.

Cunningham - Well, we think it is in the public interest . . .

Chairman Budge - To allow a violation of your own rules?

Haack - Some of our Governors and our lawyers are concerned but this is the brinkmanship because of the impact on the customers if we closed the doors.

Chairman Budge - But if have a net capital rule and permit firm to accept new customers. Who has the responsibility if someone is hurt?

Haack - Exchange and its members have a great responsibility.

Chairman Budge - Let's get specific - what is the responsibility in say a case like Hayden Stone?

Commissioner Smith - When Ira Haupt occurred, no special trust fund but no customer was hurt.

Question asking - if Hayden Stone or Dempsey Tegeler had to be closed - is there any change in public responsibility of the Exchange beyond the $20 million trust fund?

Cunningham - Moral - yes Legal - no

Chairman Budge - Don't know what that means

Haack - Our obligation increases as we allow firms to work problems out.

Commissioner Smith - What if that exceeds $20 million trust fund. Have there been any discussions about increasing the size of the trust fund?

Cunningham - Yes (discusses - Frankhauser task force) Not convinced that is the answer -

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Commissioner Needham - Then what is the answer? Getting into philosophy now which not really pertinent.

Chairman Budge - I disagree, we have a right to know what the Exchange plans to do if they turn out to be wrong in these problem cases.

Commissioner Needham - Perhaps the Exchange is attempting to assume too much responsibility - How do you feel about a program like the FDIC? If can't answer how much you are willing to commit - What about the FDIC concept?

Commissioner Needham - Problem is what is the Exchange willing to do if firm has a problem? We - SEC - need to know what NYSE is willing to do.

* * *

Commissioner Needham - Does the staff have comments about legal rights to not permit withdrawal of subordinated capital?

Chairman Budge - We would not permit this under our capital rules why should we exempt your capital rules where this is treated differently?

Haack - I would favor changing our rule to track with commission rule.

Cunningham and Bishop - We agree

Commissioner Needham - Isn't it time to restudy capital rules and maybe come up with a uniform treatment - maybe a new approach.

Other exchanges rely on NYSE to police dual members.

Are you telling the NASD and other exchanges of dual member problem firms?

Time has come to sit down - on a prospective basis - on what should be done. Concerned with the public interest.

Haack - No question about that.

Chairman Budge - Please go back to your presentation.

Cunningham - (Begins discussing Gregory and others)

Commissioner Smith - Do you have any estimate on recapture of special trust funds in Gregory?

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Haack - About all of it.

Commissioner Smith - I have heard that DuPont's situation was not good.

Cunningham - (Discusses DuPont situation)

Commissioner Needham - Who is DuPont-Laird? Not a conduit for foreign money is it? Not Eurodollars is it?

Would you pick this up in reviewing the subordinated account? Would you know if $s came from a Swiss bank account?

I am just asking - I don't know if this is involved. But you have procedures which would detect if this is Swiss bank account money.

Commissioner Smith - Is DuPont one of the firms that is losing money?

Commissioner Needham - This firm leads the hit parade in customer complaints.

Commissioner Needham - This is an indication that they are still having problems?

Cunningham - (Discusses DuPont and other problem situations)

Commissioner Needham - What about lease-backs?

Bishop - (Discusses lease-back situation - One place where NYSE rule is harsher than the SEC rules)

Commissioner Needham - Should the legal opinion be included under SEC rule 17a-5 as experts under the Act?

Bishop - Why not wait and see what results.

Cunningham - (Discusses "fails" statistics)

Chairman Budge - Does it concern you that the "fails" from the six days in October have not gone away?

Cunningham - Have gone away (discusses "fail" statistics). Will be a drop in the report for December. Two week cycle - up then down.

Chairman Budge - When will fails go down?

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Cunningham - (discusses fails) still making progress.

Chairman Budge - Looking at the page where stated that 3.2 days is normal, than say "same time in 1968 the figure was 2" days.

Cunningham - Volume up 29% in October, down ___% in November, have already caught up with the increase. (Discusses aged fails)

Commissioner Smith - Recall then when aged fails got manageable we were going to look at fails of less than 30 days old. Is it time now - since 30 day aged fails are down - shouldn't we set a new work goal, i.e. shorter period than 30 days?

Cunningham - Hope to have a "fail less society" for NYSE stocks.

Commissioner Smith - Isn't that somewhere down the road?

Cunningham - Is a Goal for 1970 for the NYSE. Problem is not NYSE stocks.

Chairman Budge - The problem is the OTC stock in the NYSE firms.

Commissioner Smith - Still suggest that consider taking a shorter work period than 30 days. Start thinking about 25-20 days. Wrong to let people think that if is in 30 days it is okay.

Commissioner Smith - Interesting to see what portion (or percent) of the 1968 - 1969 volume figures are block trades.

Chairman Budge - Does that mean that the volume discount income is 7% less?

Bishop - No 7% less volume but 20-30% less commission income.

Chairman Budge - Helpful to us to have that figure - which we will probably get at the end of the year.

Cunningham - (Discusses audit extensions and customer complaints, CCS).

Cunningham - (Discusses bank and clearing problems

1. OTC clearing
2. Bank transfer facilities
3. C.O.D.'s
4. Physical handling of certificates
5. Each of machine readable documents.)

Haack - Discusses meeting with the banks.

Commissioner Needham - Been suggested to SEC that the banks are the SEC's problem. Requires coordination - of which banks are but a part - maybe SEC could play this role. Establish

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

a task force, SEC lending its prestige and good offices. How do you feel about this as an SEC activity?

Cunningham - Maybe able to address quicker through what we have done working through CCS. Try and get First National City and another bank in CCS in say 6 months. If so we could come back in 6 months. If not work, we would come back in 6 months.

Commissioner Needham - Is Arthur Little Report better than North American Rockwell Report?

Cunningham - Yes (discusses reports)

Commissioner Needham - So many studies - feel that somebody is trying to redesign the wheel - when comes to implementation - differences in opinion as to what should be done.

Chairman Budge - What about cusip?

Commissioner Needham - Saying no need for Commission to step in at this time?

Cunningham (Discusses program with the banks)

Commissioner Needham - What representation from the regional exchanges?

Cunningham - None

Commissioner Smith - Is there any value - in dealing with banks - in bringing the bank regulatory agencies into the matter?

Commissioner Smith - Have we seen the audits of CCS?

Cunningham - Happy to supply it.

Commissioner Smith - Would be of interest to see the audit report.

Commissioner Needham - What would be a reasonable date to assess whether banks will follow through with participation in CCS?

Will you let us know how you make out?

Cunningham - (Discusses Federal Reserve and bearer treasury instruments - banks cooperated fully)

Hope in year 1970 to have all clearing banks in CCS.

Haack - Have indicated to regionals that there will be a satellite system around the country.

PLAINTIFFS' EXHIBIT 109 FOR IDENTIFICATION

Commissioner Smith - Be interested in knowing status of machine readable certificates and registrars.

Commissioner Smith - Haven't said anything about registrars publicly.

Cunningham - Intend to allow transfer agent to be registrar.

Commissioner Smith - Separate registrar is tremendously wasteful practice.

Cunningham - Guess we will put registrar problem back on the list.

Cunningham - (Discusses machine readable certificate - won't see it for at least a year).

end
5:17

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E-188

PLAINTIFFS' EXHIBIT 69 FOR IDENTIFICATION

Tom Jolt Post 11/23/70



Market Insecurities

JACK ANDERSON

WASHINGTON.

The nation's 35 million investors not only are plagued by plunging stock prices and piling paperwork, but the brokers who handle stock transactions are so poorly regulated that they have been getting away with law violations.

This column has turned up evidence, including official documents labeled "confidential," that the securities market is policed by most reluctant regulators.

The New York Stock Exchange, for instance, has shown a strange leniency toward brokerage firms that have been caught fleecing their customers. The Securities and Exchange Commission, set up to protect the public, has also been slow to act.

Some brokerage firms, meanwhile, have blacklisted employes who cooperated with officials to expose wrongdoing.

* * *

In one case, it took Congressional heat to get the SEC to move against 12 Lockheed officials, who are accused of dumping company stock because they had inside dope on a cost scandal before it hit the headlines. They knew that Lockheed had overcharged the Air Force for the controversial C5A transport plane.

The SEC took testimony from only eight witnesses during its first four months of investigation. Not until Rep. John Moss (D-Cal.) began asking angry questions did the SEC begin swearing in witnesses and sending for field reports.

Yet even now, eight months after the probe began, there is no SEC report and no action against any of them.

Even more curious is the case of McDonnell & Co., a 65-year-old brokerage firm whose activities have shaken the securities community.

Documents show the scandal was in motion as early as Oct. 21, 1968. The SEC learned that McDonnell hadn't complied with the "net capital" provision of SEC regulations, a vital clause that protects the investor.

While the SEC dilly-dallied, McDonnell struggled to set things right. But corporate goofs, including a computer snafu and law violations by McDonnell employes, soon had the firm on the edge of crisis.

The company hired former Postmaster General Larry O'Brien, a man with excellent political connections, as president. But he quit after seven months, as one confidential document puts it, over "the firm's financial difficulties."

Another official investigative record charges McDonnell with violations "of virtually every major SEC and New York Stock Exchange rule governing broker-dealers." These include:

"Failure to comply with the net capital rule, failure to comply with the margin requirements of the Federal Reserve Board, manipulations of customers' accounts (and) falsification of actual purchase or sale prices to customers."

* * *

McDonnell's problems forced it to shut down or sell all but three of its 26 offices, and to cut back drastically in other areas. In all this, the SEC took minor suspension action and the Stock Exchange indulged in similar wrist-slapping.

In fairness, McDonnell did fire or suspend some offending employes. Now, a year later, there is still no SEC report.

It would be unfair to lay the fault entirely at SEC's door. The watchdog agency rushes from case to case like an overworked fire department unable to put out any one fire properly. Congress is clearly to blame for small-mindedly assuming that the miserly staff and ramshackle rules set up when old Joe Kennedy headed the SEC in the 30s are adequate for the stock market explosion of the 70s.

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PLAINTIFFS' EXHIBIT 85 FOR IDENTIFICATION

July 18, 1970 Business Week



Arning: member firms' marriage broker

THE MARKETS

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Making brokers toe the mark

Big Board is forcing its weaker firms to shape up or sell out

Lee D. Arning laughs when reminded that Wall Street refers to him as "Marryin' Sam." But when he thinks about all the mergers of member firms, branch office consolidations, and cutbacks that he has promoted or ordered as vice-president for operations at the New York Stock Exchange, he turns grimly serious. "Look," he says, "this is a tough and nasty game. Member firms had the right to run their own businesses for a long time. Now we are taking that option from them. It's a rude awakening."

The Big Board, of course, is not responsible for all the retrenchment on Wall Street. Many brokerage house chief executives reacted on their own to the boom market and plunged ahead with expansion programs that left them overextended when the bear market hit. But the most drastic cuts, and the merging of firms out of existence, almost always were at the behest of Arning and the Big Board's member firms department.

Usually Arning does not come across as a harsh man. He smiles readily and says his 6-ft. trim frame probably has been beaten down an inch or so in the past year by Wall Street's problems. Under him are the stock list, member firms, and floor departments. But he has devoted most of his time, by far, to the member firms department, where he oversees 270 employees, including 60 examiners who prowl through brokerage house records.

Of the 90 brokerages that are gone from the exchange's roster of 645 a year and a half ago, "two-thirds went under because of capital problems. "It was just a question of time for survival," he says, meaning that he told a firm "either to get so strong as to be beneath our requirement or get out."

Minimums. Before this year, a firm was required to keep its ratio of net indebtedness to liquid capital below 15:1, which was the exchange's early warning mark. (At 20:1, a firm would be forced out of business "in a matter of hours," says Arning, implying that he does not allow a firm's ratio to get even that high.) But in the first quarter this year, the Big Board toughened the rule; the ratio, it said, had to be under 12:1, and operating losses for a month could not exceed 15% of excess capital. If capital was the problem, the firm usually was allowed no more than a week or two to get it in line. The grace period was longer for operating losses. "At the time we warn them, the prerogatives [for corrective action] are management's," says Arning.

The more conservative rules forced member firms to start cutting back on personnel and branches and, in many cases, to start looking for a willing merger partner. "We helped by becoming a marriage broker," says Arning. Often his men would ask a healthy firm what kind of organization it might want to acquire and where it wanted to add branch offices. Then they would introduce it to a firm in trouble. Other times, they would help a firm rid itself of most capital requirements by lining up a stronger brokerage to handle the clearing function.

If the ailing firm fails to get in shape within the allotted time, then the exchange steps in and, as Arning explains, "sees that it goes out of business." Though he is reluctant to say how often this procedure has been followed, one brokerage house partner insists that many cases, which looked like mergers, "actually were liquidations." Customer accounts and assets were picked up, but the acquiring firm had no responsibility for the other firm's liabilities. Even Arning admits that very few of the combinations actually are mergers. "The joining of F. I. du Pont with Glore Forgan Staats and Hirsch is a true merger, but that is kind of rare," he says.

Lucky day. For the scores of firms that were given warnings and got themselves in shape, the exchange's tougher rules are now a blessing. Many had been reluctant to cut back until forced, because they thought the days of big volume would return. But volume has remained modest, and they are in leaner, better shape to handle it. In fact, management consultants for Wall Street firms say that most turned in their first profitable month in June and that for the year, 50% now are losing money, a vast improvement from the 70% of a month earlier.

Arning, though, is not relaxing. He points out that 40 firms are still in his early warning zone. Three weeks ago, he said in a speech: "I will say unequivocally: There are going to be fewer firms. There are going to be stronger firms."

Most of Wall Street is all for that, and some brokers go so far as to credit the Big Board with "saving the financial community." But others point out that had the exchange taken a tougher look at capital rules several years ago, many of today's problems would have been avoided. Others claim the exchange has not shown enough foresight

> 'I say unequivocally: There will be fewer firms, there will be stronger firms'

in the combination of firms it has arranged, especially in allowing Schwabacher & Co., a troubled West Coast firm, to become part of Blair & Co. early in 1969. As a result of the merger, Blair now has problems and last week announced an agreement to transfer 15 of its offices to Thomson, McKinnon & Redpath.

Though other member firms say they took one look at Schwabacher and turned it down, Arning says that at the time it looked like a sound acquisition for Blair. And he says he pored over a thick packet of material outlining the feasibility of the du Pont merger before the Big Board approved it.

Arning is quick to defend the net capital rule, too. He claims that McDonnell & Co. and Gregory & Sons, two firms that violated the 20:1 ratio and had to dip into the exchange's emergency funds when they were liquidated, were "special circumstances." Normally, he says, a firm would meet all its obligations if it liquidated at 20:1. Nonetheless, he plans to submit to the Board of Governors in October a redesigned net capital rule that will be "stronger and more conservative."

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PLAINTIFFS' EXHIBIT 86 IN EVIDENCE

Pres. Office

NEW YORK STOCK EXCHANGE
ELEVEN WALL STREET
NEW YORK, N. Y. 10005

SPECIAL MEMBERSHIP BULLETIN

86-19

ROBERT W. HAACK
PRESIDENT

October, 1970

TO: Members and Allied Members

SUBJECT: Report on Self-Regulation

As you know, the past three years have been a period of perpetual crisis for the securities industry. What is not generally appreciated is the severity of the crisis or the monumental pressures placed on the Exchange as a self-regulatory organization.

Attached is a report dealing with some of the major policies and decisions of the Exchange during this period. Here is a brief summary of that report:

The paperwork crunch of 1968-1969 and the severe profits squeeze that followed required the Exchange to intervene actively at one time or another in the affairs of 196 member firms, more than half of all member firms doing business with the public.

The 196 total represents on an unduplicated basis 105 firms that at one time or another were on Exchange restrictions because of severe paperwork problems, and 139 firms that were monitored by the Exchange in 1970 under the "early warning" surveillance program because of financial problems. Collectively, these firms carried more than 2.2 million customer accounts; represented a combined aggregate indebtedness of more than $3.46-billion.

Obviously, failure of a substantial number of these firms would not only affect the financial well-being of other member organizations and the Exchange but also the strength and liquidity of financial markets throughout the United States and abroad.

Significantly, of these 196 firms, only about 8% have had to be suspended or liquidated by the Exchange as of this date.

What precipitated this three-year crisis period was the fact that in late 1967 and in 1968 the most active securities markets in history overwhelmed the industry's paperwork processing capacity. From April-July 1968 over one billion shares traded on the Exchange, more than the total volume of as recent a year as 1962.

To help stem this problem and prevent a widespread loss of records control, the Exchange and other major industry organizations put into effect some 30 measures, ranging from Wednesday market closings to restrictions on the business of problem firms. At the height of the problem in June, 1968, 47 firms were under restriction. By September, 1968, the total was 28; three months later there were 12. Today no firm is under restriction due to paperwork problems.

As the paperwork crunch ensed, one of the severest financial squeezes in the industry's history began. The squeeze was caused by a decline in trading volume and sharply dropping prices which created severe operating losses and eroded the capital of member firms. To cope with this problem, the Exchange in 1970 developed an early warning program designed to identify firms with substantial operating losses and depletion of excess capital, requiring them to come up with programs to either cut losses, get additional capital, or take other steps to improve their financial condition.

As of September 30, this is the status of the 139 firms that have been monitored during 1970 by the early warning program:

.. Ninety-three firms have stopped or reversed the trend of capital losses.

.. Five firms transferred their accounts to other firms but remained in operation as introducing firms.

.. Sixteen others merged, consolidated or sold their business to other firms.

.. Eight terminated business and delivered out accounts, or are doing so, including some firms in formal liquidation. This does not include four firms in liquidation before the early warning system was in effect.

.. Seventeen firms, while presently in compliance with NYSE net capital rules, continue to operate under close Exchange monitoring while they take steps intended to improve their capital position.

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AN EXCHANGE REPORT: SELF-REGULATION AT A TIME OF CRISIS

The crisis of the last three years in the securities industry is well known; not so generally appreciated or understood is the magnitude of the crisis and the monumental pressure placed on the Exchange as a self-regulatory organization during this period. The paperwork crunch of 1968 and 1969 and the severe financial squeeze that continues has required the Exchange to intervene actively in the affairs of more than half of its member firms doing business with the public. The scope of this task and what has been at stake is indicated by the fact that these 196 firms represented combined aggregate indebtedness of more than $3.48-billion and carried more than 2.2 million customer accounts.

These pressures continue, and much remains to be resolved. But it is important today to review the response of self-regulation to crisis thus far. This report to the membership deals with the nature and severity of the paperwork problem and what was done about it; the dimension of the capital crisis in member organizations and the steps being taken to deal with it; and effort underway to develop additional Exchange self-regulation tools.

SUMMARY OF EVENTS

In late 1967 and in 1968, the most active securities markets in history overwhelmed the industry's paperwork processing capacity. The cascade of paperwork into brokerage offices, banks and transfer agents was unprecedented from April-July, 1968, more than one billion shares traded on the Exchange, a total about equal to the entire year's volume for 1929 and more than total volume of as recent a year as 1962. The 1929 record of 16.4 million shares traded in a single day was broken 25 times in 1968. Volume on the American Exchange and in the over-the-counter markets also ran at levels never before experienced. So great was the backlog of paperwork that by December, 1968, th value of securities not delivered by brokers within the prescribed five-day period reached $4.1-billion--a level about four times that of today.

In an effort to stem this mounting problem and prevent a widespread loss of records control, the Exchange and other major industry organizations put into effect some 30 measures ranging from Wednesday market closings to increas penalties for long-standing failures to deliver securities. The industry and the banks worked together to try to clear bottlenecks in securities processin and ownership transfer. Highest priority was given to industry and to firm automation projects that sought to replace with electronic impulses the milli of pieces of paper that shuttle between brokers and between brokers and banks Key projects such as the Exchange's Central Certificate Service--aimed at immobilizing the stock certificate by accomplishing delivery of shares betwee brokers by computer--underwent accelerated development. Brokerage firms expanded clerical staffs; some worked almost round-the-clock on paperwork backlogs. The effect of these many efforts, together with a lessening of pressure on the firms as volume fell in 1969, brought a decline in the paperwork problem as 1970 began.

For the Exchange, the regulatory problem was twofold. Besides working to slow the flood of paperwork and improve processing procedures, there was the problem of dealing with firms with unusually severe record-keeping proble This job was in itself monumental: at one point or another during 1968 or 1969, a total of 105 firms had paperwork problems that required restrictions on their business.

Exchange-imposed restrictions were critical in coping with the paperwor problems of troubled firms. In June, 1968, at the height of the problem, a total of 47 firms operated under restrictions. By September, 1969, the total had fallen to 28, and by last December, 12 firms remained on restriction. At present, no firms are under restriction due to paperwork problems.

As the paperwork crunch abated one of the most severe financial squeeze in the history of the industry began. In late 1969 and in 1970, income from almost every phase of the securities business was slashed amid steadily falli stock prices. Average daily volume on the Exchange fell 12% in 1969 from the

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Stock Exchange volume fell 22% in 1969 alone. Unlisted trading probably declined more. For an industry spending at an estimated annual rate of $100-million for automation alone, this trading volume decline had drastic effects on operating results. Of 54 retail, or publicly oriented, firms sampled in 1970, less than one-third had managed to make a profit on commission business in the last quarter of 1969. During the first four months of 1970, only one-fifth of these firms were able to avoid losses on commission business.

Operating losses formed only part of the picture. A sustained decline in stock prices, which dropped average values of NYSE issues alone some 38% from late 1968 to late May, 1970, eroded the net capital in firms and brought heavy losses in trading inventories. The combination of these financial blows, coming as firms were shaking off the paperwork problem, was devastating.

Again, the scope of the regulatory problem was immense. To date during 1970, the Exchange has identified and worked closely with 139 firms with financial problems in an effort to improve operating results and strengthen capital positions.

As of September 30, these have been the results of the work with these firms:

- Ninety-three of the 139 firms stopped or reversed the trend of capital loss and continued to operate as independent entities.
- Five firms transferred all accounts to other firms but remained in operation as introducing firms, no longer carrying customer accounts.
- Sixteen merged, consolidated or sold their business to other firms.
- Eight have terminated business are delivering out accounts, including some firms in formal liquidation. This does not include four firms in liquidation before the early warning system was in effect.
- Seventeen firms, while presently in compliance with NYSE net capital rules, continue to operate under close Exchange monitoring while they take steps intended to improve their capital position.

At the end of September, some 98% of member firms required to meet net capital rules had capital ratios more favorable than 12-to-1, the ratio now being used as an "early warning" guideline. Some 67% had ratios more favorable than 5-to-1.

METHODS OF REGULATION

The drastic reduction in the number of firms with serious operational or capital problems was accomplished by a joint effort of the Exchange and personnel of member firms. The major elements of the Exchange's approach are described below.

1. Restrictions

The policy of restrictions on the business of firms in operational trouble, begun in April, 1968, was unprecedented. It was the key weapon in attacking the paperwork problem. The scope of 21 possible restrictions ranged from bans on advertising and promotional activity to fixed limits on the number of orders that could be written both for public customer and firm accounts. Most severe were restrictions barring a firm from accepting any order which would bring in new customer funds or make it necessary to deliver securities to the firm.

This was a "rifle" approach, with sanctions aimed at the individual problems of each firm. For example, in addition to the most common restrictions banning the hiring of salesmen and the opening of new branches, a St. Louis firm was made to suspend both underwriting and trading for its own account. A San Francisco firm was told to introduce its accounts to other firms. A New York firm was barred from soliciting further over-the-counter business as well as from solicitation of margin business. Exchange examiners during this period concentrated on firms with the most severe paperwork problems, following up monitoring efforts with field visits to check compliance and operations

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While applying these restrictions, the Exchange worked closely with the Securities and Exchange Commission, keeping the Federal regulatory authorities frequently advised by letter, written reports, personal visits and telephone calls on the status of member firms.

2. Coordinator System

To impose and enforce restrictions and monitor progress, the Exchange's Department of Member Firms early in 1968 began to reorganize. By the Fall, a team of six executives was coordinating the flow of operations and financial reports reviewed by the Department's staff of 120 operations and financial surveillance people.

These reports include three financial and four operations filings due each year from all firms carrying public accounts, field reports by examiners, and special reports by firms in operations or capital difficulty. The workload is large: in June, 1970, the Department reviewed 176 special financial questionnaires, 25 audited financial questionnaires, 512 profitability statements, and 168 special operations questionnaires.

The coordinators, assigned financial and operations specialists to help interpret reports and speed the flow of data, provide a concentration of Exchange resources on known problem firms. Coordinators work closely with firms, suggesting methods for improving financial conditions and evaluating progress.

3. Financial Early Warning

With the financial squeeze of late 1969 and 1970, the Exchange concentrated on trying to single out and work with firms whose capital was being eroded at a potentially dangerous rate. An "early warning" approach was developed, centered again in the coordinator system. All firms were required to file capital computations and profit and loss statements monthly. Although the Exchange's net capital rule technically allows a firm's aggregate indebtedness to be 20 times its net capital, the Exchange had used a guideline for review purposes of 15-1. In March, this guideline was lowered to 12-1, and firms showing larger debt-capital ratios were required to file detailed plans and timetables for cutting operating losses and adding new capital. In addition, firms whose monthly losses came to more than 15% of excess net capital were required to file plans and undergo monitoring, since six months of continued losses at these levels would bring capital violation.

The effect of these policy changes was to bring more firms under special surveillance at an early stage so that early remedial steps could be taken.

Depending on their financial condition, such firms are monitored weekly; in some cases, daily. They must show adequacy of steps to cut and control operating expenses, to increase capital, to project probable operating results over several months, to speak to the suitability of current salary levels for officers, partners and employes, and to the risks involved in continuing securities positions. In addition to close surveillance by the Exchange staff, conditions of these firms currently are reviewed twice weekly by a special committee of the Board of Governors.

PRACTICAL SELF-REGULATION

Practical self-regulation involves more than the development of techniques and enforcement of rules. In a crisis, such as the industry has experienced, the effect of actions must be weighed against the possibility of large-scale customer losses in problem firms as well as impact on other brokerage firms and their customers in the U. S. and abroad.

For example, in the case of three major member organizations, the Exchange found itself facing situations where normal application of rules could have meant possible loss for many thousands of customers and potential chaos in the

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industry. These firms, Dempsey-Tegeler & Co., Inc., McDonnell & Co., and Blair & Co., carried a combined total of some 165,000 customer accounts. Their paperwork and capital problems were critical. Dempsey-Tegeler's operations problems were among the most severe in the industry; indeed, Exchange restriction had already cut its daily volume in late 1968 from 4,500 trades to 1,500. McDonnell and Blair found themselves engulfed in paperwork problems as a result of attempted conversion of operations to automated systems during periods of heavy volume.

With each firm, the Exchange allowed continued operation under increased regulation, pending a scaling down of business and reduction of paperwork backlogs. The hope was a scaled-down firm would present a manageable liquidation situation. These factors were behind this belief:

.. The severity of paperwork problems in these firms and the great number of customer accounts involved would not have allowed orderly liquidation had the firms been suspended. For example, errors in stock records alone would have required many months, perhaps years, to resolve customer stock ownership and location of shares. The Exchange felt that the only way to avoid an indefinite tying up of many thousands of customer accounts was to continue operations while directing the firm's resources toward a clearing up of the paperwork backlog.

.. Suspension could have emptied these firms of clerical staff at a time of intense competition among brokerage firms for skilled operations employes. The demands of liquidation are great: for example, Pickard & Co., a small firm with 3,500 accounts suspended by the Exchange in 1968, required 30 Exchange examiners working more than 18 months with the help of firm employees and auditors to resolve errors in records.

.. Announcement of suspension of these major firms could have prompted a run by customers on firms which did not have a problem. With investor confidence shaken, the effect even on healthy firms might have been major. The chain effect of these events could have been grave.

Here is the extent of the reduction in operations and in some of the paperwork problems in these three firms up until the start of formal liquidation or termination of business:

Aggregate Indebtedness: $326-million to $128.7-million

Accounts: 165,000 to 90,500

Branches: 127 to 6

Fails to Deliver: $62.2-million to $9.8-million

Fails Over 30 Days: $18-million to $3.9-million

The three firms now in liquidation have a total of 30,000 accounts to be delivered out. Even at this stage, with substantial researching of records still to be resolved, the ultimate cost to complete delivery of customer accounts is not clear.

Hayden, Stone

Another example of Exchange efforts during the paperwork problem and capital crisis involved Hayden, Stone, Inc., a nationwide retail firm. The recent transfer of the bulk of Hayden, Stone accounts to Walston & Co., Inc. and to Cogan, Berlind, Weill & Levitt, Inc. occurred after almost two years of intense effort by the firm -- working under close Exchange regulation -- to cope with severe paperwork and capital problems.

This 88-year-old firm was hard hit by the paperwork problem early in 1968. An Exchange operations questionnaire filed in April, 1968 showed a large volume of unresolved bookkeeping differences, plus stock-transfer and dividend record

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problems. The firm itself in May developed a series of voluntary restrictions including limits on promotional activity and expanded sales capacity and specific restraints on transactions causing heaviest record-keeping problems. Clearing activities for other firms were terminated and Hayden, Stone's operations department was reorganized and expanded.

Despite a concentrated effort to clean up its backlog of paperwork, the firm's operational condition worsened during the peak volume of mid-1968. In August, the Exchange ordered Hayden, Stone not to hire salesmen beyond those needed to replace persons leaving the firm. In September, restrictions on advertising and promotion became mandatory. While substantial improvement was made in the level of undelivered securities, major problems remained in the frequency and dollar value of bookkeeping differences and stock-transfer and dividend problems. During June, the firm's average trades per day were at a peak of 9,150. By late 1968 this was down to 7,500 per day and Exchange restriction lowered this to a limit of 6,500 daily. The firm terminated 200 salesmen and closed 10 branch offices in the first of what was to be a series of cutbacks in operations. Exchange restriction by year-end 1968 also required weekly -- instead of monthly -- operations reports.

During 1969, Hayden, Stone made major strides to solve its record-keeping problems, but substantial problems remained, including a persistent dividend record backlog. In September, the Exchange censured and fined the firm $150,000 for violations in 1968 of Exchange record-keeping rules.

Like many other firms already weakened by having to devote substantial money and resources to clearing paperwork problems, Hayden, Stone found itself facing capital problems as volume declined, as securities prices continued dropping, and word of the firm's troubles caused loss of customers and key sales personnel. In 1969, operating expenses -- swelled by paperwork correction costs -- totaled $60.2-million and Hayden, Stone logged a net operating loss of $10.8-million for the year.

The Exchange directed the firm to improve its capital position through cost-cutting and addition of new capital. A steady reduction in expenses was accelerated in May, 1970, when Hayden, Stone realigned its executive management and set up a program designed to reduce expenses by some $830,000 a month. The payroll was cut by 400, the pay of salaried employes reduced by 10% and pay of officers holding voting stock by 15%. At the same time, arrangements were completed for the acquisition of additional capital from a group of investors which was intended to give the firm an excellent chance to return to normal operation. Some $12.4-million of new capital was expected, but the market decline reduced this to $4.4-million by late August. In June, the firm began to liquidate securities held in subordinated accounts to remain in capital compliance. To further reduce business and cut operating costs, Hayden, Stone in late August transferred to Walston & Co., some 20,000 accounts in 17 branch offices.

Despite the effects of major cutbacks in operations, the firm's net operating loss for the first seven months of 1970 totaled $9.2-million. These results and extensive drains on the capital did not permit the firm to continue as an independent operation.

The thrust of the Exchange's effort in the case of Hayden, Stone was to direct an orderly reduction in operations that would permit either survival or eventual termination of a sharply reduced business. In late 1968 and 1969, a breakdown in record-keeping was avoided -- one that could have had drastic consequences in the industrywide operations crisis at the time. With the firm's subsequent capital problems, the Exchange worked to limit the exposure both of customers and the industry to financial loss by directing major reductions in activity. The firm also received assistance from the Special Trust Fund.

Reductions in the scope of Hayden, Stone's operations and in its paperwork backlog were major. From December, 1968 to August, 1970, offices were cut from 82 to 45. Customer accounts in that period were reduced from 157,000 to 90,000; aggregate indebtedness was cut from $333-million in December, 1968 to $88.9-million at the end of July, 1970. In paperwork problems, the value

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of undelivered securities fell from a peak of $118-million in June, 1968, to $3.6-million in July, 1970. The value of outstanding "fails to deliver" securities over 30 days was reduced from a peak of $30-million in July, 1968 to less than $400,000 two years later. The value of bookkeeping differences, $111-million in August, 1968 were whittled to $3.7-million in July, 1970.

New Directions

The paperwork problem in its broadest terms represented the failure of a cumbersome and complex system--one that can require as many as 60 documents to complete a single transaction--to cope with record demand. Much has been done to improve the system. More remains to be done. Laws must be changed so paperwork processing can be simplified. Industrywide automation must be expanded. More concerted action is needed by the major industry organizations and the banks to improve procedures.

To intensify its operations surveillance, the Exchange is developing formal operations standards for all firms, so that objective evaluation of paperwork processing capability can be made more quickly.

The substantial cleanup of the paperwork problem combined with the development of the Exchange's early warning system were major factors in a decision by the Board of Governors in July to place a maximum limit of 15 days for correction of a capital violation before suspension.

Firms with current records should be able to liquidate with their own resources. In fact, probably more than 90% of estimated potential costs of liquidating the firms under the Exchange's Special Trust Fund stem from record-keeping problems in these firms.

The capital rule itself will undergo strengthening and its scope will be broadened. For many months, the Exchange has been conducting a formal study of better means to measure solvency and liquidity in member organizations. The experience of the last several years indicates that perhaps other factors in addition to net capital must be taken into account. Other important measures of the financial strength of a firm include its operating capacity, its own system of early warning and management capability, its profitability, and its ability to attract and hold new and more permanent capital. Another key indicator is the credit-worthiness of a firm in the eyes of its bankers.

Expansion and refinement of the capital rule will represent the views not only of the Exchange but of the financial community as well. A special Board committee is expected to have initial policy recommendations for October's policy meeting of the Board and will then continue its review.

In addition, a plan of limited industrywide protection for securities customers of broker-dealers generally is contained in legislation before the Congress to create a Securities Investor Protection Corporation funded by the securities industry and backed by stand-by credit of up to $1-billion from the Treasury. This legislation is supported by the SEC, the Treasury Department, and the entire industry as well as the Exchange. Every effort is being made to have the SIPC legislation enacted within the coming weeks and good progress is being made. Similarly the proposed new commission schedule, which is pending with the SEC, should be acted upon very soon.

In summary, during these three crisis years, the Exchange has used a variety of new rules and surveillance methods, tempered by the practical business judgment of its staff and Governing Board, in an attempt to cope with the problems that resulted from the historic volume upsurge of 1968-69 and the relentless profits squeeze of the past year. Obviously, it was not possible to insulate the entire industry from the economic consequences of these severe problems. The Exchange has tried to hold impact to a minimum on the investing public, on the financial markets, and on the member organizations themselves.

New York Stock Exchange
October 1, 1970

PLAINTIFFS' EXHIBIT 86 IN EVIDENCE

A question often asked is why did the Exchange allow a few major member firms to continue in business despite critical paperwork and capital problems. This was the case, for example, in 3 major firms, Dempsey-Tegeler & Co., Inc., McDonnell & Co., and Blair & Co., with a combined total of 165,000 customer accounts. In each case, the Exchange allowed continued operation under increased regulation, pending a scaling down of business and reduction of paperwork backlogs to manageable proportions.

These were the key reasons for this approach:

.. The severity of paperwork problems in these firms and the great number of customer accounts involved would not have allowed orderly liquidation had the firm been suspended. Errors in stock records alone would have required many months, perhaps years, to resolve.

.. Suspension could have emptied these firms of clerical staff at a time of intense competition among brokerage firms for skilled operations employees. Demands of liquidation are great: for example, Pickard & Co., a small firm with 3,500 accounts suspended by the Exchange in 1968, required 30 Exchange examiners working more than 18 months with the help of firm employees and auditors to resolve errors in records.

.. Announcement of suspension of these major firms could have prompted a run by customers on firms which did not have a problem. With investor confidence shaken, the effect even on healthy firms might have been major. The chain effect of these events could have been grave.

Under this scale-down approach, here is an aggregate summary of how the business and paperwork backlogs of the three firms were reduced up to the time of their formal liquidation or termination of business:

Aggregate Indebtedness: $326-million to $128.7-million

Accounts: 165,000 to 90,500

Branches: 127 to 6

Fails to Deliver: $62.2-million to $9.8-million

Fails over 30 days: $18-million to $3.9-million

The three firms now in liquidation have a total of some 30,000 accounts that remain to be delivered out. Even now, with substantial researching of records still to be resolved, the ultimate cost to complete delivery of customer accounts is not clear.

The case of Hayden, Stone, Inc. shows somewhat the same approach. Here the Exchange worked closely with a firm in order to reduce its size and record-keeping problem -- and thereby reduce potential customer and industry loss. The recent transfer of the bulk of Hayden, Stone accounts to Walston & Co., Inc. and to Cogan, Berlind, Weill & Levitt, Inc. occurred after almost two years of intense effort by the firm, working under Exchange restriction and surveillance, to reduce sharply the size of its operations and the amount of unresolved paperwork. From December, 1968 to August, 1970, branch offices were cut from 82 to 45. Customer accounts were reduced from 157,000 to 90,000; aggregate indebtedness was cut from $333-million in December, 1968 to $88.9-million at the end of July, 1970. In paperwork reductions, the value of undelivered securities was cut from a peak of $118-million in June, 1968, to $3.6-million in July, 1970. The amount of outstanding over-30 day fails fell from a peak of $30-million, in July, 1968 to less than $400,000 two years later. Bookkeeping differences that totaled $111-million in August, 1968, were whittled to $3.7-million in July, 1970.

While the paperwork problem of 1968-1969 is over, its residual effects are still being felt. More than 90% of estimated potential costs of liquidating firms under the Exchange's Special Trust Fund stem from record-keeping problems. The substantial clean-up of the paperwork problem combined with development of the Exchange's early warning system permitted the Board of Governors decision in July to place a 15-day maximum limit for correction of a capital violation before suspension.

The Exchange feels it has major tools in its early warning surveillance system, its coordinator concept and its "rifle" approach to deal with operational and financial problems of member firms. Meanwhile, additional self-regulatory tools are being developed, including: strengthening of capital rules; developing formal operations standards; and working with industry groups to improve overall operations capacity and simplify paperwork processing.

Robert W. Haack

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

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DEPARTMENT OF MEMBER FIRMS

October 22, 1970

TO: The Board of Governors

FROM: Department of Member Firms, McDonnell & Co., Inc. and T. Murray McDonnell

SUBJECT: Statement of Facts and Offer of Consent by McDonnell & Co., Inc. and T. Murray McDonnell for Violations of Exchange Rule 325 (Capital), 440 and SEC Rule 17a-3 (Books and Records), 417.11 (Audit), 402 and SEC Rule 8c-1 (Segregation of Securities) and 342 (Supervision and Control)

STATEMENT OF FACTS

In March 1968, McDonnell & Co., Incorporated was a member firm with its main office in New York, 26 branch offices, 307 registered representatives, 881 employees and 28 voting stockholders. In addition, it did a substantial professional business as a "rights specialist" on the Exchange Floor. The firm had been a member of the Exchange since March 15, 1917, changing to corporate form on January 1, 1959.

An audit as of October 1967, received by the Exchange in late February 1968, disclosed substantial unidentified fails, unidentified transfers, unlocated securities differences, and error accounts. Consequently, on March 18, 1968, the firm was restricted from adding branches or registered representatives and a short time later was directed not to make any further commitments of any kind that would tend to increase business.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

Executives of the firm met with the Exchange and were convincing concerning the adequacy of their planning and capacity to overcome current problems. The formal restrictions, consequently, were removed on April 19, 1968, but the corporation was cautioned to be conservative in its production expansion plans in the light of a pending computer conversion and heavy securities industry volume.

At that time the firm reported that it was well advanced in testing an advanced computer system designed by Data Architects, Inc. which was scheduled to be put into use in stages in the early fall. The firm had adequate capital at this time to absorb as charges the various known record-keeping errors.

A large data processing computer was installed in the firm in April 1968 in anticipation of the conversion. However, at this time one of the two smaller computers was removed from the firm, halving the firm's capacity to handle trading volume on its old system.

When conversion attempts were made in the early fall, the first parts of the system proved unsatisfactory. Conversion was consequently deferred month by month.

In June 1968, Sean McDonnell, Executive Vice President of the firm, died unexpectedly. He was the firm's chief executive in day to day sales supervision, operations, and planning.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

Thomas McKay had been for a number of years the firm's chief operations officer and was known to the Exchange as reliable, knowledgable and forthright. His evaluation of the firm's problems and developing solutions to these problems had been accepted by the Exchange during 1968. In May 1969, Mr. McKay was hospitalized with cancer and died a few weeks later.

In January 1969, Lawrence F. O'Brien, former Postmaster General, was named President of the firm to fill the void caused by the death of Sean McDonnell. Inasmuch as he had no previous securities industry experience, the Exchange did not consider Mr. O'Brien as having major compliance duties and continued to rely on T. Murray McDonnell, Chairman and Chief Executive to exercise the principal supervisory responsibility required by Rule 342.

The firm's 1968 audit started on October 31, and results were analyzed by Exchange examiners on January 27, 1969, showing the firm to be in capital violation. The firm immediately showed plans for improving its capital position by about $2½ million through the deposit of additional securities in accounts of existing subordinated lenders, new subordinated lenders and the sale of common stock to old and new stockholders and in mid-February reported on their Special Operations Questionnaire signed by T. Murray McDonnell, that their end-of-January ratio was 1,979%.

The firm also voluntarily imposed restrictions similar to those which the Exchange otherwise might have imposed. Exchange examiners visited the firm in mid-February 1969 and reported in mid-April that the records were then currently posted with the exception of certain work in the margin department, but that the ledger accounts and stock record contained the cumulative effects of operation with an inadequate system over a period of many months, as shown in Exhibit A. The examiners concluded that errors were so numerous that the accurancy of any capital computation prepared without a detailed audit would be questionable. The examiners also detected serious deficiencies in segregation, as shown in Exhibit B, and in customer account records, as shown in Exhibit C.

In March, Examiner analyses also demonstrated that the firm's report that it was in capital compliance at the end of January was erroneous, and substantial doubt was placed on the firm's then current capital computations which were showing capital compliance. On April 21, the firm was instructed to begin liquidating proprietary securities to improve capital and on April 28, Murray McDonnell arranged a personal loan of $1 million for subordination to the firm and an additional $650,000 on May 19.

Consequently, the Exchange in May formalized the firm's own restrictions as Exchange restrictions and placed a limit on the number of trades per week which the firm could do.

During the spring of 1969, the firm still intended to convert to the new computer system. The first stage became operational on March 17, 1969. However, in mid-June Data Architects advised that it would be unable to meet another target date of June 30th.

The Operations Questionnaires filed with the Exchange by the corporation in the period May 1968 to March 1969 and meetings with the firm's management did not reflect the depth of problems shown by the audit reported in January, 1969 and Exchange examiner's visit of February - April, 1969. It is not now feasible to determine whether the substantial misrepresentation to the Exchange in this period arose from an inability by the firm's systems to produce truly indicative numbers or from suppression of the true facts somewhere in the McDonnell organization. Unless there was deliberate misrepresenting to the Exchange by top management, it seems clear that top management did not have the degree of supervision and control of firm operations required by Rule 342. Representative figures for the Operations Questionnaires of this period are shown in Exhibit C.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

In May, 1969, another Examiner reported that the firm's capital problems came principally from stock record differences and after a follow-up visit in June he indicated that these differences and other areas had improved substantially.

In July, 1969, the firm employed Mr. Henry C. B. Lindh, former operations partner at Faulkner, Dawkins & Sullivan, as the firm's chief operations officer to succeed Mr. McKay. After reviewing the problems with the Data Architects, Inc. computer system, Mr. Lindh recommended, and the firm determined, not to continue the conversion to it but rather to convert to the established systems of Automatic Computer Services. This was done successfully in early September, 1969

In late July, 1969, the firm was unable to meet Exchange capital requirements and unable to raise additional capital. They determined to sell some Exchange seats and to cut back substantially on their branch office operations. By mid August their plan was to reduce their 26 branches to 7.

Mr. Paul McDonald, an executive with experience in reorganization of troubled businesses, was engaged in August 1969 to be agent of the corporation to conduct its business, and in October was named President and chief executive. He instituted and carried out a drasti program of cost reduction and liquidation of proprietary positions.

When the firm's equity was depleted to the point of not meeting the requirements of Rule 315.14, stockholders voted a recapitalization to restore the firm to compliance. Subsequently, the firm determined to retain only three offices and to emphasize an institutional and professional business. In late January 1970, they had 26 registered representatives and 297 employees and from a high of approximately 50,000 accounts in mid-1969, there then remained 26,000, 16,000 of which were expected to be delivered out and 10,000 retained.

On March 13, 1970, the corporation announced that it had concurred with the New York Stock Exchange in a plan for the gradual termination of the firm's business.

VIOLATION OF RULE 342

Rule 342 provides that each office, department or business activity of a member organization shall be under the supervision and control of the member organization and of the personnel delegated such authority and responsibility. The above facts indicate that the operations of the corporation were not under reasonable supervision and control. Mr. T. Murray McDonnell as Chairman of the Board and Chief Executive Officer during the period of the violations had overall responsibility for supervision and control.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

CHARGES

On the basis of the above Statement of Facts and supplementary exhibits, the Department of Member Firms charges:

1. That McDonnell & Co., Incorporated violated Rule 325, as shown in Exhibit D.

2. That McDonnell & Co., Incorporated violated SEC Rule 17a-3(11) by failing to prepare a computation of aggregate indebtedness and net capital at least once a month as shown in Exhibit E.

3. That McDonnell & Co., Incorporated violated Rule 417 by not having their answers to a regular financial questionnaire as of October 26, 1967, October 31, 1968 and December 19, 1969, submitted to the Exchange within the time period required by Rule 417 as shown in Exhibit F.

4. That McDonnell & Co., Incorporated violated Rule 440 and SEC Rule 17a-3 in failing to maintain books and records on a current and accurate basis as shown in Exhibits A and C.

5. That McDonnell & Co., Incorporated violated Rule 402 and SEC Rule 8c-1 by failing to segregate customers' securities properly and promptly as shown in Exhibit B.

6. That T. Murray McDonnell is the officer of McDonnell & Co., Incorporated principally responsible for the above violations.

7. That T. Murray McDonnell violated Rule 342 in failing to maintain supervision and control over the operations of McDonnell & Co., Incorporated.

8. That Mr. McDonnell is subject to discipline under Sections 6, 7, 13, 14, 17 and 19 of Article XIV of the Exchange Constitution.

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PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

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EXHIBIT A

VIOLATION OF BOOKS AND RECORDS RULES

The examiner's review of the books and records during the period February 18, to April 8, 1969, disclosed the following:

1) The stock record differences from the audit at October 31, 1968, and not resolved were still substantial. At January 30, 1969, there were 1,113 long differences with a market value of $6,943,779 and 514 short differences with a market value of $875,811.

2) The non-current dividends receivable reported in the January 30, 1969, Special Financial Questionnaire are cash - $337,287 and short securities with a market value of $1,287,986. The majority of the stock dividends were considered by the dividend department as "to be researched."

3) The error account reported in the January 30, 1969, Special Financial Questionnaire showed long values of $5,471,002 and short values of $3,221,096 and it required 32 pages to list the detail. This account was the consolidation of balances and positions from about 25 different accounts.

4) A "Reorganization" account had been established to handle exchanges, tenders and redemptions. However, it had become a "dumping ground" for unresolved transactions. An equity statement showed that at January 30, 1969, it also contained securities with long market values of $1,919,773 and short market values of $2,954,995.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

EXHIBIT B

VIOLATION OF SEGREGATION RULE

During their visit, the examiners performed a limited test of segregation as of February 21, 1969, by comparing the positions reported on the stock record to a physical count of securities in the vault and to that which was reported by Central Certificate Service. Thirty-one random selected securities were used and the following number of differences were noted between the count and stock record positions:

Positions	Total Differences	Count or Comparison Over	Count or Comparison Under	Invalid Long Position
Vault	13	6	6	1
CCS	5	2	3	
	18	8	9	1

In view of the results, the test was expanded to include other street-side locations. Additional differences between positions on the stock record and physical counts and comparisons of the locations are as follows:

Positions	Total Differences	Count of Comparison Over	Count or Comparison Under	Invalid Long Position
Transfer	21	4	16	1
Fail to Receive	2		2	
Safekeeping	7		7	
Box 2/21/69	No count made, note - Invalid Positions			7
Box 2/27/69	19	3	11	5
Bank Loan	4		4	
Stock Loan	4		3	1

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

The stock record manager was apprised of the number of differences, and in effect attributed the differences to bad key punching, location of the securities in the audit difference accounts, swings between street side locations and bad counts.

The review of the segregation operations undertaken utilized the stock record as of February 21, 1969. The stock record indicates the amount of shares ordered into segregation by the margin department and the number of shares that are actually segregated by the Cashier's Department.

For the thirty-one securities used in the aforementioned test count, the stock record indicated that 24 positions were undersegregated. It was noted in several cases that the undersegregated positions were due to the securities being in transfer. However, in other cases the stock was found to be available for segregation in other locations, such as, the Box, Stock Loan, and in Bank Loan.

Following are examples of undersegregated stock positions and locations of the shares necessary to correct the condition based upon the February 21, 1969, stock record:

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PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

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Name of Security	# of Shs Order Segregated	# of Shs Segregated	Locations of Stock Available for Segregation
r Cyanamid	11220	6360	2400 Shs B/L, 4745 Shs [illegible]
ysler Corp.	28339	21548	7000 Shs B/L, [illegible] Shs [illegible]
rchild Hiller	6335	4850	2600 Shs B/L, 610 Shs [illegible]
el Inc.	1006	77	1200 Shs B/L, 132 Shs Box
	1822	1161	640 Shs BOX, 184 Shs [illegible]
aid	6972	3119	(3300 Shs S/L, 251 Shs Box
			(3600 Shs B/L, 1072 Shs [illegible]

The stock records dated February 14, 27, and March 7, 1969 indicated approximately the same undersegregated condition relative to the positions.

The October 31, 1968, audited financial questionnaire disclosed fully paid for securities not segregated:

In box and transfer - $37,631,179
Pledged against money borrowed - $26,261,635

The corporation explained that the existence of this condition was caused by delayed computer runs, increased volume, inexperienced personnel and delayed transfers because of slow processing by transfer agents.

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PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

EXHIBIT C

ERRORS IN CUSTOMER'S ACCOUNTS

The examiner's review of customer's accounts maintained for the corporation's Washington, D. C. office, disclosed numerous differences and errors in these accounts. The differences and errors primarily consisted of the following:

1. Erroneous trades in accounts not cancelled which were found in some instances to be many months old.

2. Entries were sometimes made to the customers' statement but not to the transfer posting record received by the margin department and vice-versa.

3. Entries were sometimes posted to the wrong customers' accounts.

4. Trades and entries were sometimes posted to cash accounts in error instead of margin accounts and vice-versa. These erroneous entries were found in some instances to have been overlooked by the margin clerk for many months.

5. Negligence in the transferring of money from the margin account to the cash account as payment for securities purchased.

6. It often took months to convert convertible stocks or bonds to the new security. This conversion is the responsibility of the reorganization department.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

EXHIBIT D

VIOLATIONS OF CAPITAL RULE

Exchange Rule 325 requires that no organization transacting business directly with the public shall permit its Aggregate Indebtedness to exceed 2,000 percentum of its Net Capital, which Net Capital shall not be less than $50,000 in the case of a member organization carrying any accounts for customers.

An audit was made as of October 31, 1968, by the corporation's independent accountants. The answers to the financial questionnaire as of that date were due on extension on December 30, but were not filed until January 16, 1969. An analysis of the answers disclosed the following capital position:

Aggregate Indebtedness	$114,516,105
Net Worth	16,610,810
Net Capital Required	5,725,806
Net Capital	4,557,930
Net Capital Deficiency	1,167,876
Ratio	2,512%
Proprietary Positions	18,736,000

As of January 30, 1969, the corporation filed with the Exchange answers to a Special Financial Questionnaire. Analysis on March 18 of these answers disclosed the following:

Aggregate Indebtedness	$118,265,000
Net Worth	19,082,006
Net Capital Required	5,913,250
Net Capital	3,968,000
Net Capital Deficiency	1,945,250
Ratio	2,981%
Proprietary Positions	23,802,000

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

During the period February 18 to April 8, 1969, Exchange examiners visited the corporation to determine the corporation's net capital and the condition of its books and records. In the course of the examination certain errors and omissions were noted in the preparation of the answers to the Special Financial Questionnaire as of January 30, 1969. The exceptions noted by the examiners were applied to the analysis of the answers and the revised capital position resulted in a capital ratio of 3,920%.

The corporation has for some time submitted "estimated" capital positions to the Exchange on a weekly basis. According to these computations there have been at least seven occasions when the capital ratio was in excess of 2,000%:

6/16/69	2,359%
6/23/69	2,353%
6/30/69	2,191%
7/ 7/69	2,569%
7/14/69	2,332%
7/31/69	2,151%
12/12/69	2,010%

In addition, the Special Operations Questionnaire prepared by the corporation as of June 26, September 26, and November 28, 1969 showed ratios of 2,813%, 2,239% and 2,099%, respectively.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

EXHIBIT E

VIOLATION OF SEC RULE 17a-3(11)

This SEC Rule requires the maintenance of a record of the computation of aggregate indebtedness and net capital to be prepared currently at least once a month.

In reviewing the corporation's own capital computation, Exchange examiners noted that detailed computations were made only for January through May and for July in 1968. Estimated computations were made weekly throughout the year. The estimates were not based on a detailed analysis of the books but consisted instead of an adjustment each week of the prior week figures based on known major changes.

PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

EXHIBIT 1

VIOLATION OF RULE 17

The audited questionnaire as of October 26, 1967, was due on extension on February 6, 1968, but not received by the Exchange until February 20. The answers to the audited questionnaire as of October 31, 1968, were due on extension January 13, 1968, but not filed until January 16. The answers to the audited questionnaire as of December 19, 1969, were due on February 7, 1970. A request for an extension of time to submit the answers was denied. The answers were submitted to the Exchange on March 18, 1970.

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PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

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EXHIBIT G

STOCK RECORD DIFFERENCES REPORTED BY McDONNELL & CO. ON SPECIAL OPERATIONS QUESTIONNAIRES

DATE	# OF DIFFERENCES	LONG MARKET VALUE	SHORT MARKET VALUE
March 1968	690	$1,469,704	193,180
April 1968	259	900,999	150,290
May 1968			
June 1968			
July 1968			
August 1968			
September 1968			
October 1968			
November 1968	2544*		
December 1968	2017**	9,252,538	1,345,868
January 1969	1627	6,943,779	895,811
February 1969	1503	6,791,488	778,937
March 1969	1212	5,620,056	584,739
April 1969	867	4,060,676	220,716
May 1969	597	2,827,178	192,407
June 1969	1126	1,463,000	603,000
July 1969	832	583,059	332,334
August 1969	280	163,171	129,376
September 1969	2220	Not Determined	Not Determined
October 1969	1281	Not Determined	5,904,000
November 1969	674	Not Determined	Not Determined
December 1969	3487	6,352,000	9,697,000
January 1970	3176	5,445,000	7,933,000

*Auditors figures - values not known
**Revised auditors figures

The differences reported in April 1968 were resolved by May 1968. From May until November 1968 no differences were reported as firm had not physically counted securities pending the conversion of their record keeping system to IBM (Data Architects).

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PLAINTIFFS' EXHIBIT 83 IN EVIDENCE

NEW YORK STOCK EXCHANGE
DEPARTMENT OF MEMBER FIRMS

OFFER OF SETTLEMENT OF T. MURRAY MCDONNELL

In conformity with the provisions of Article XIV, Section 14 of the New York Stock Exchange Constitution, T. Murray McDonnell makes the following Offer of Settlement and Consent to the Board of Governors. Compliance with the provisions of paragraph 1, Section 14 and Section 12 of Article XIV of the Exchange Constitution is hereby expressly waived.

It is hereby agreed that T. Murray McDonnell for the purposes of these proceedings only, without admitting any violation of law, and for no other purposes admits the matters specified in the Charge Memorandum of the Department of Member Firms, dated October 22, 1970, and is subject to discipline by the Board of Governors of the Exchange, pursuant to Article XIV, Section 6 of the Exchange Constitution.

The foregoing agreements and waivers are made on the condition that the Board of Governors of the Exchange impose a penalty on T. Murray McDonnell, which is hereby consented to, of suspension as a registered representative for a period of 12 months, of which 10 months are to be remitted in view of factors in mitigation and extenuation, such period of suspension to begin on the date of acceptance of this Offer of Settlement by the Board of Governors. In addition, T. Murray McDonnell further consents to the imposition of a penalty that hereafter he will not make application for, nor be granted, the position of an allied member or member of the Exchange or any supervisory position with any member or member organization of the Exchange.

It is further agreed that the Exchange may give notice of this Offer of Settlement and Consent and the subject matter thereof pursuant to Article XIV, Section 19 of the Constitution.

NEW YORK STOCK EXCHANGE

Robert M. Bishop
Vice President and Director

T. Murray McDonnell

NYSE EXHIBIT GGG IN EVIDENCE
[Original]

November 6, 1969

Mr. Robert A. Price
Department of Member Firms
New York Stock Exchange
[illegible] - 21st Floor
[illegible]
New York, New York 10004

Dear Mr. Price:

In accordance with our agreement to furnish you with a [illegible] financial statement, we enclose our [illegible] capital position as of October 31st, 1969.

Very truly yours,

[illegible] & CO., INCORPORATED

Henry C. B. Lisch
Senior Vice President

[illegible]

enclosure

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

Mr. Joseph O. [illegible]
Chief of Broker-Dealer Inspections
Securities & Exchange Commission

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NYSE EXHIBIT GGG IN EVIDENCE
[Original]

McDONNELL & CO., INCORPORATED

AGGREGATE INDEBTEDNESS

	October 31 1969	October 27 1969	Increase (Decrease)
Money Borrowed - Customers	$30,200,000	$30,400,000	$ (200,000)
Securities Loaned - Customers	4,310,000	5,042,000	(732,000)
Securities Failed to Receive - Customers	2,950,000	4,087,000	(1,137,000)
Customers Free Credit Balance	7,620,000	8,081,000	(461,000)
Customers other Credit Balances	13,300,000	14,827,000	(1,527,000)
Other Liabilities	2,080,000	2,283,000	(203,000)
	$60,460,000	$64,720,000	$(4,260,000)

NYSE EXHIBIT GGG IN EVIDENCE
[Original]

McDONNELL & CO., INCORPORATED

ESTIMATED CAPITAL POSITION

OCTOBER 31, 1969

Aggregate Indebtedness	$60,460,000
Net Capital (1)	$3,710,000
Capital Ratio (1)	1,630%
Market Value of Proprietory Securities	$9,580,000
Net Worth	$8,730,000

NOTE:

(1) After deducting the following computed as of August 28, 1969:

Market value non-current short dividend positions - 100%	$1,044,000
Market value short security differences - 30%	-
	$1,044,000

Before deducting above:

Net Capital	$4,754,000
Capital Ratio	1,272%

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NYSE EXHIBIT GGG IN EVIDENCE

[Retyped Copy]

GGG XQ

November 6, 1969

Mr. Robert A. Spies
Department of Member Firms
New York Stock Exchange
4 New York Plaza - 21st Floor
at Broad & Water Streets
New York, New York 10004

Dear Mr. Spies:

In accordance with our agreement to furnish you with a weekly capital computation, we enclose our estimated capital position as of October 31st, 1969.

Very truly yours,

McDONNELL & CO., INCORPORATED

Henry C. B. Lindh
Senior Vice President

HCBL:bf

enclosure

cc: Mr. G. H. Newman
Department of Member Firms
New York Stock Exchange

Mr. Joseph O. Barton
Chief of Broker-Dealer Inspections
Securities & Exchange Commission

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NYSE EXHIBIT WWW IN EVIDENCE

WWW-D

LOMBARD VITALIS PAGANUCCI & NELSON

Member New York Stock Exchange 111 Broadway New York, N.Y. 10006 (212) 267-4100 Cable: Tickertape

November 19, 1970

Mr. Robert M. Bishop, Vice President
New York Stock Exchange
4 New York Plaza
New York, New York 10004

Dear Mr. Bishop:

This reply is submitted in response to your memorandum of charges forwarded to me by letter dated October 26, 1970. I must deny all your statements of alleged fact contained in the charges because they are lacking in validity and furthermore it is apparent that any admission would encourage legal actions against, among others, me, McDonnell & Co. Incorporated and the New York Stock Exchange. More to the point, by order of settlement with the S. E. C., without admitting or denying any of the allegations of the order, or any violation of law and for the purpose of settlement only, I consented to a permanent barring from any managerial or supervisory position with any broker-dealer. I negotiated in good faith after a full investigation by the S. E. C. and agreed to this settlement under which the commission permitted me to at least earn a living for myself, wife and nine children as a stock broker. To consent to any suspension, in addition, appears to me as unduly harsh and inequitable in view of all the circumstances.

NYSE EXHIBIT WWW IN EVIDENCE

Stated in a sentence, the charge now made against me is that the Operations Department of McDonnell was lacking in management control and there is the implication that the management of McDonnell may have misrepresented facts to the Exchange to conceal the true condition, which ostensibly explains why the Exchange did not act itself during those years to protect the public interest.

As Chief Executive Officer of one of the largest member firms in the country I did not--- and could not--- know of some of the alleged operations violations, when they were occurring. To suggest that the Chief Executive Officer of a firm our size can know the daily details of the Operations Department is to indulge in a fiction.

Consistency would require that every Chief Executive Officer of every member firm now found to have violated these regulations be similarly suspended for two years.

I respectfully submit that it is not fair to hold me personally culpable for the results that ensued after the general manager of the business, my brother Sean McDonnell, who died suddenly in June of 1968.

I respectfully submit that it is not fair to hold me personally culpable for the fact that management did not have reliable figures with which to maintain control for the ensuing several months after the Comptroller of the company, Stan Grees, died suddenly in November of 1968. In addition Thomas McKay the firm's chief operations officer died suddenly in May 1969.

NYSE EXHIBIT WWW IN EVIDENCE

I respectfully submit that it is not fair to hold me personally culpable for the incompetence of Data Architects and their inability to meet the contract which they had entered with McDonnell to automate back-office procedures.

I took every reasonable action for a Chief Executive Officer in order to provide the company with prudent operating management, from the hiring of McKinsey & Co. Inc. in 1968, and Lawrence O'Brien as President in 1969 down to the ultimate hiring of H. C. B. Lindh and Paul McDonald to protect public interests. So far as my personal service is involved, the memorandum of facts prepared by the Exchange documents the diligence with which I acted as Chief Executive Officer.

To the extent that the company allegedly operated in technical violation of some regulations, there is clear reason why we continued to operate despite the violations. The Department of Member Firms of the Exchange repeatedly urged the company to continue despite the alleged violations because the alternatives of suspension were inconceivable at that time. Violations now recited were known to the Exchange while they were occurring and oral waivers were given by the Department of Member Firms to continue while making best management efforts to correct the problems.

Such efforts were vigorously made with the encouragement and collaborati of the Exchange. Again, your statement of facts documents the history of waiver and ratification to which I refer.

Thus a question is raised as to the authority of Exchange officials to interpret and to enforce Exchange regulations. The position now

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taken by the Department of Member Firms argues that we should have ignored their oral directives and suggestions, and that they were not personally authorized and responsible in so directing us. Repeatedly the management of McDonnell was advised by officers and employees of the Exchange that the regulations were subject to various interpretations under some of which we could be considered not in violation. We were further advised by these same persons that the arithmetical calculations regarding compliance could be arrived at in different ways under some of which we would not be found in violation. We were assured by innuendo, by oral statements, and by policy decisions that the regulations and the arithmetic would be so construed as to find McDonnell not in violation of these regulations while we made every effort to save the firm.

Your memorandum of charges conspicuously omits any factors in mitigation or extenuation. My father founded this firm in 1905 and it was identified as a "rights" house because of its reputation as a specialist on the Exchange. I joined the firm after my education and overseas military service in World War II and undertook most jobs from the bottom to the top. In 1957 I commenced a broadening of the business by acquiring sales, operations, research and corporate finance talent in a program of building an investment service with branch offices across the country.

From a relatively modest business base of three million dollars at that time, the firm grew steadily to a twenty four million dollar gross income in 1967 with 26 branches and capital of over sixteen

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million dollars. The company offered a wide range of services to individual investors, banks, institutions, corporations and dealers. It was a member of the Exchange holding four seats, and a member of the American Stock Exchange with two seats and of six regional exchanges.

We gave employment to 1,300 people, of whom over half were located in New York City. We had over 350 registered representatives, and professional employees in Research, Investment Management, Underwriting, legal and other staff departments totaled over 100.

A sales training program started in 1967 was accelerated in 1968 to staff greatly expanding sales facilities by providing for the registration of 97 sales representatives at a cost of $618,000 which was approximately $300,000 in excess of such spending for 1967. Our customers totaled over sixty five thousand active accounts, among which were leading banks and institutions across the country.

For over sixty years it was the purpose of the firm to maintain the highest standards of ethics and integrity in the conduct of its business.

My own charitable activities included chairmanships of the Committee on Education for the Archdiocese and the Executive Committee of St. Vincents Hospital. I am a trustee of St. Vincents Hospital and Brandeis University as well as being a member of the Cardinal's Committee of the Laiety and first vice president of Catholic Youth Organization.

The crisis of the last three years in the securities industry is well known. In late 1967 and in 1968, the most active securities markets in history overwhelmed the industry's paper work processing capacity. As the Exchange itself has stated, the cascade of paper work into brokerage

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offices, banks and transfer agents was unprecedented. Unfortunately the magnitude of this crisis has overwhelmed many firms with McDonnell one of the first to go. The Exchange itself allowed McDonnell to continue in business despite its critical paper work and capital problems.

To exact a suspension of me and deprive me of a living, at this time would cause me severe personal hardship. I personally am liable for over two million dollars as a result of this liquidation. Not only am I being held personally liable for over $1,650,000 plus interest that I borrowed to put into the firm to save it but I am currently a defendant in a score of proceedings throughout the country. I have been strongly advised to commence personal insolvency proceedings. In addition to substantial losses of my own, immediate members of my family including my mother, wife, sisters and brothers have personally lost over seven million dollars.

In view of all the foregoing I submit that a disposition of this proceeding along the lines of the S. E. C. order of settlement would be fair and equitable and allow me to continue to earn a living under the close supervision of my current employer.

Respectfully submitted,

T. Murray McDonnell

T. Murray McDonnell

PLAINTIFFS' EXHIBIT 105 FOR IDENTIFICATION

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

NOV 25 1970

105 D

Mr. Robert W. Haack, President
New York Stock Exchange
Eleven Wall Street
New York, New York 10005

Dear Mr. Haack:

In at least two respects, your letter dated November 20, 1970 on behalf of the Exchange appears to reflect a lack of appreciation of fundamental aspects of the federal securities laws. The first relates to the essence of broker-dealer net capital requirements and the proper response on the part of those who administer them when they discover non-compliance. The second appears to display a misconception of the role and responsibility of a national securities exchange under the Securities Exchange Act of 1934 ("the Act").

In your letter, you point out that Article XIII of the New York Stock Exchange Constitution provides, among other things, that the summary suspension power of the Board of Governors must depend upon at least one of several specified findings, including the one that a member organization "is in such financial or operating condition that it cannot be permitted to continue in business with safety to its creditors or the Exchange." It is plain from this and your August 3 and 31 letters that the Exchange does not share the Commission's views that the very circumstance of non-compliance by a member organization of the Exchange with its net capital requirements compels the finding that such organization is in such a financial condition that it cannot be permitted uninterruptedly to continue to carry on business as usual with safety to its customers and other creditors.

In this connection, we call your attention to Section 15(c)(3) of the Act which (in conjunction with Section 15(b)(4)) prohibits any registered broker or dealer from effecting any transaction in, or inducing the purchase or sale of, any security (with minor exceptions not here pertinent) otherwise than on a national securities exchange, in contravention of Commission rules and regulations in the public interest and for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers. As you know, the keystone of the financial responsibility requirements adopted by the Commission under this Section is Rule 15c3-1 under the Act. The vital principle to be distilled

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from the unequivocal provisions of Section 15(c)(3) is that a broker or dealer who is not in compliance with Rule 15c3-1 is by that circumstance alone prohibited from engaging in any over-the-counter business. Stated otherwise, a basic tenet of the Act is that, when a broker or dealer is not in compliance with the Commission's rule, he is in such a financial condition that he cannot be permitted to continue engaging in over-the-counter business with safety to his customers and other creditors. By the same token, the provision in paragraph (b)(2) of the Rule exempting members in good standing of specified exchanges (including the New York Stock Exchange), upon the assumption that their "rules, settled practices, and applicable regulatory procedures" are more comprehensive than those of Rule 15c3-1 is necessarily founded on the premise that the non-compliance by a member organization of such an exchange should, at a minimum, result in the same consequences to such a member as regards discontinuing all over-the-counter business as apply to non-member brokers or dealers who violate the Commission's rule. Moreover, in the event of the violation of an exchange member of the self operative net capital provisions of Section 8(b) of the Act (see e.g., Guy D. Marionette, 11 S.E.C. 967, 968, n. 2 (1942)), the unfitness of that member to continue engaging in transactions on an exchange is similarly axiomatic. Accordingly, it is clear that non-compliance by a member organization of the New York Stock Exchange with its net capital requirements establishes alone that the organization is in such financial condition that its continuing to carry on business endangers the safety of its customers and other creditors.

The second point relates to the observation in your letter that, should the Commission withdraw the exemption provided for exchange members by subparagraph (b)(2) of Rule 15c3-1, "the Commission would then have the primary responsibility for administering the net capital rule with respect to NYSE member organizations and the Commission could begin proceedings to revoke the firm's broker-dealer registration if it determined that any net capital violation merited that action." If this is intended to convey that, in the event of a violation of Section 8(b) or 15(c)(3) by one of its member organizations, the Exchange would be relieved of its direct responsibilities under Sections 6(b) and 6(d) of the Act to expel, suspend, or discipline a member for wilful violation of any provision of the Act or any rule or regulation thereunder, such a stance would fly in the face of the statute and the conclusions of the Supreme Court in Silver v. New York Stock Exchange, 373 U.S. 341, 352-357 (1962). On the contrary, the design of the Act in affording special privileges to national securities exchanges is to place upon such exchanges the immediate and primary role and responsibility of "leadership" in enforcing the Act and the rules and regulations thereunder with regard to its members (Silver v. New York Stock Exchange, 373 U.S. at p. 352)).

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We believe that the Exchange must recognize these fundamental principles if it is to fulfil its statutory obligations. We, of course, stand ready to assist you in any way we can.

Sincerely,

Hamer H. Budge
Chairman

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Case Study of the Interpretation and Enforcement of the Net Capital Rule of the New York Stock Exchange

PREFACE

This case study of the interpretation and enforcement of the net capital rule of the New York Stock Exchange ("NYSE") has been prepared by the staff of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs. The staff has relied primarily upon published materials and upon the files of the Securities and Exchange Commission ("the Commission"). The Commission has cooperated in every respect in making its files available to the staff.

Some of the documents reviewed by the staff were contained in nonpublic files of the Commission. The NYSE has not had an opportunity to review such nonpublic materials and in some instances contests the validity or accuracy of statements contained therein.

It should be understood that the focus of the study is procedural rather than substantive. The relationship between the NYSE and the Commission is examined in the context of the self-regulatory framework established by the Securities Exchange Act of 1934. No attempt is made to determine the proper components of a "good" net capital rule.

Because of the large number of events and the volume of correspondence relating to the NYSE net capital rule during the financial crisis of the late 1960's no attempt at comprehensive treatment has been made. Rather, those events which may directly or indirectly bear upon the self-regulatory process have been selected.

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Staff Study of the Interpretation and Enforcement of the Net Capital Rule of the New York Stock Exchange

I. STATUTORY BACKGROUND; COMMISSION RULE 15C3-1; NYSE RULE 325

In attempting to restore public confidence in the securities markets after the crash of 1929, the Securities Exchange Act of 1934 ("the Act") addressed not only manipulative and unfair practices, but also sought to protect customers against the risk of broker insolvency by limiting the amount an exchange member could borrow in relation to its net capital.[1] Section 8(b) of the Act [2] makes it unlawful for any exchange member, or any broker or dealer who transacts a business in securities through the medium of a member, directly or indirectly—

> To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons including customers' credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the [Securities and Exchange] Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 8(b), however, applies only to broker-dealers who transact business through the medium of a stock exchange member. For this reason, and because of other technical difficulties,[3] the Securities and Exchange Commission ("the Commission") has chosen to rely primarily on section 15(c)(3) of the Act [4] to assure financial responsibility of brokers and dealers.[5] Section 15(c)(3), which was added in 1938, prohibits *any* broker or dealer from making use of the mails or of any means or instrumentality of interstate commerce to effect any trans-

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[1] 2 L. LOSS, SECURITIES REGULATION 1350 (2d ed. 1961).
[2] 15 U.S.C. § 78h(b) (1970).
[3] See, *e.g.* 2 L. LOSS, *supra* note 1, at 1350. For example, section 8(b) relates only to a broker-dealer's business *as a broker* making it difficult to determine when a violation has occurred.
[4] 15 U.S.C. § 78o(c)(3) (1970).
[5] It should be noted, however, that section 8(b) of the Act is and has been treated as self-executing. The Commission has proceeded against broker-dealers for violation of the statute even though no rules have been promulgated thereunder. See 1 SPECIAL STUDY OF THE SECURITIES MARKETS 407 n. 377, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as "Special Study"]. See also H.R. Rep. No. 1383, 73d. Cong., 2d Sess. p. 20 (1934). Moreover, the absence of definitions for the terms "aggregate indebtedness" and "net capital" in section 8(b) has not stopped the Commission from excluding securities having no ready market from net capital. See, *e.g.* Guy D. Marianette, 11 S.E.C. 967 (1942).

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action in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances or commercial bills)—

> in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers. . . .

Pursuant to section 15(c)(3) of the Act the Commission adopted the forerunner of its present net capital rule on October 29, 1942.[6] Since that time the Commission's rule 15c3-1 has been "one of the most important weapons in the Commission's arsenal to protect investors."[7] The Commission's rule, as recently amended, imposes a minimum net capital requirement of $25,000 on most brokers and dealers and borrows from the theory of section 8(b) of the Act in imposing a maximum 20:1 ratio between "aggregate indebtedness" and "net capital" upon all broker-dealers subject to the rule.[8] The term "aggregate indebtedness" includes (with certain exceptions) the total money liabilities a broker or dealer arising in connection with any transaction whatsoever.[9] And,

> in computing "net capital" the broker's or dealer's net worth (assets minus liabilities) is adjusted, among other ways, by adding unrealized profits or deducting unrealized losses in his own accounts, as well as adding equities or deducting deficits in the accounts of partners; deducting altogether fixed assets and assets which cannot be readily converted into cash (less any indebtedness secured thereby); excluding liabilities which are the subject of a satisfactory subordination agreement; and deducting specified percentages ("haircuts" varying from 5 to 30 percent) of the market value of all non-exempted securities long and short in the accounts of the broker or dealer and its partners.[10]

A very important exemption from the Commission's net capital rule excludes from its operation members in good standing of seven named stock exchanges (including the New York Stock Exchange) "whose rules, settled practices and applicable regulatory procedures are

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[6] SEC Securities Exchange Act Release Nos. 3323 (Oct. 29, 1942) & 3602 (Aug. 11, 1944).

[7] See Blaise d'Antoni & Associates, Inc. v. SEC, 289 F. 2d 276, 277 (5th Cir. 1961), *rehearing denied*, 290 F. 2d 688 (5th Cir. 1961), cert. denied, 368 U.S. 899.

[8] 17 C.F.R. 240.15c3-1(a). Recent amendments impose an 8:1 ratio upon broker-dealers commencing business during the first 12 months of their existence. SEC Securities Exchange Act Release No. 9653 (June 14, 1972).

[9] 17 C.F.R. 240.15c3-1(c)(1).

[10] 2 L. Loss, *supra* note 1 at 1354. (Citations omitted.) The adjustments required in computing net capital under the Commission's rule reflect its philosophy that Congress intended financial responsibility rules for brokers and dealers to result in instant liquidity. [See, e.g. Guy D. Marianette, 11 S.E.C. 967 (1942); Stock Exchange Regulation, Hearings Before the House Comm. on Interstate & Foreign Commerce, 73d Cong., 2d Sess. at 87 (1934).]

Application of the "haircut" provisions in computing net capital is illustrated by the present rules 15c3-1 (SEC) and 325 (NYSE) which, for example, require the following deductions from market value of securities, long and short (except exempted securities) in the capital, proprietary and other accounts of brokers and dealers:

	Percent
Most common stocks	30
Future commodity contracts	30
Securities failed to deliver:	
40–49 days old	10
50–59 days old	20
60 days or over	30

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deemed by the Commission to impose requirements more comprehensively than the requirements" of the Commission's rule.[12] This provision, which is terminable upon ten days written notice by the Commission, has two primary effects. First, it means that most of the largest broker-dealers in the nation and those who account for the great majority of the securities business in the country are not subject to rule 15c3–1.[13] Second, the exemption serves to insulate members in good standing of the named exchanges from Commission enforcement of *any* net capital rule. The Commission does not have the power to directly enforce exchange rules (*viz.* NYSE rule 325).[15] And, it is not entirely clear that the Commission can compel national securities exchanges to enforce their own rules.

Former Commissioner Ganson Purcell testified in 1942, for example:

> Curiously enough, the act does not, however, contain any express provision requiring the exchanges to enforce those rules which are a condition precedent to its registration as a national securities exchange nor to enforce the changes in its rules which section 19(b) explicitly authorized the Commission to bring about. Thus the act contains no express agreement that the exchanges agree to enforce their own rules and regulations. Nor does it provide any express procedure whereby the Commisson can itself see that exchange rules are enforced.[14]

Thus, while the exemption from Commission rule 15c3–1 applies to members in good standing of certain stock exchanges "whose rules, settled practices and applicable regulatory procedures are deemed by the Commission to impose [more comprehensive] requirements . . .", there is little in express language of the Act which compels the exchanges to enforce or apply those rules, practices and procedures.

As stated, the NYSE's exemption from rule 15c3–1 is based upon the Commission's finding on November 8, 1944 (the day before the rule became effective) that the capital requirements of certain exchanges were more comprehensive than those imposed by the Commission.[15] The NYSE's net capital rule actually antedated that of the Commission. The forerunner of present rule 325 was established in 1939. At the time rule 15c3–1 became effective the Exchange's net

[12] On September 29, 1972 the exemption became unavailable to members of exchanges whose rules do not provide "for ratios and net capital at least equal to the minimum ratios and net capital required" by the Commission's rules. SEC Securities Exchange Act Release No. 9633 (June 14, 1972). The NYSE has provided for such ratios in a recent amendment to its rule. However, it is doubtful that this amendment will have any practical effect on Rule 15c3–1 as it has been applied by the Commission. As the case study shows, differences between the Commission's rule and those of the exchanges have not centered around the minimum ratios or net capital required by the rules themselves, but around the method of computing the ratio of individual firms.

[13] See *e.g.* Securities Industry Study, Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs for the Period Ended February 4, 1972, 92d Cong., 2d Sess. at 75 (1972).

[14] *E.g.* SEC. Study of Unsafe & Unsound Practices of Brokers & Dealers, 92d Cong., 1st Sess., H.R. Doc. 92–231, pp. 6–7 (1971).

[15] 4 Proposed Amendments to the Securities Act of 1933 & to the Securities Exchange Act of 1934. Hearings Before the House Comm. on Interstate & Foreign Commerce, 77th Cong., 1st Sess. at 1265 (1942).

Of course, the rules of the exchanges do provide for sanctions against members adjudged guilty of violations. See, *e.g.* Constitution, New York Stock Exchange, Inc., Art. IV, § 6.

It has been widely assumed in the area of civil liability, that national securities exchanges do have a statutory duty to enforce their own rules. *E.g. Baird* v. *Franklin*, 141 F. 2d 238 (2d Cir. 1944), *cert. denied* 323 U.S. 737 (1944). See also L. LOSS, *supra* note 1 at 1177–1178; N. Wolfson & T. Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 CALIF. L. REV. 1120 (1970); L. Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 19–30 (1966); Note, *Private Actions as a Remedy for Violations of Stock Exchange Rules*, 83 HARV. L. REV. 825, 829–830 (1970).

[15] SEC Securities Act Release No. 3617 (Nov. 8, 1944).

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capital rule was in fact more "comprehensive" and provided a more stringent test of liquidity. It established a 15:1 capital test for brokers and provided for greater "haircuts" against the market value of securities carried in the accounts of the firm and its partners than did the Commission rule.[16]

Since 1944 NYSE rule 325 and Commission rule 15c3–1 have been changed from time to time. Over the years rule 15c3–1 has been made more rigorous by the Commission.[17] During the same period of time NYSE rule 325 has also been modified by amendment.

Furthermore, the substance of rule 325 has been informally altered by "unpublished policies" and interpretations which have the same effect as rules.[18] In the opinion of the Commission these formal and informal changes have, on different occasions, made the NYSE rule either more or less stringent than Commission rule 15c3-1.[19] The Exchange, however, is of the opinion that at all times material to this case study, its rules have been more "comprehensive" than Commission rule 15c3–1.

One reason for the differences between the Commission's net capital rule and that of the NYSE was a philosophical disagreement as to the purposes of such rules. The Commission and its staff have historically taken the view that the rule is and should be a measure of "instantaneous" or "immediate" liquidity, invoking the legislative history of the Act in support of this position.[20] The Exchange, on the other hand, used a 30-day test of liquidity in interpreting its rule during the period covered by this case study.[21] In May of 1970, however, the Exchange suggested that the staffs of the NYSE and the Commission consider another approach in formulating an appropriate net capital rule which it designated the "operating cycle" concept of a current asset:

> Briefly, the . . . [American Institute of Certified Public Accountants] fixes the time in which an asset qualifies as a good current receivable in relation to the normal turnover or collection time of that type if [sic] receivable in normal trade practice. Applied to member organizations, this concept would lead to recognizing as good receivables some dividend claims, underwriting fees, insurance claims, and the like, whose normal collection period is longer than the 30-days which the Exchange now recognizes in its purely "liquidity" concept.[22]

In this case study we will make no attempt to assess the relative merits of the various theories of broker-dealer financial responsibility put forth by the Commission and the NYSE. But, it is important to bear in mind that some of the substantive differences which manifested

[16] 2 L. Loss *supra* note 1 at 1353 n. 246. See also H. Baruch, Wall Street Security Risk 174–176 (1971). Between Sept. 21, 1953 and Aug. 1, 1971 the minimum capital ratio required by NYSE rule 325 was 20:1, the same ratio provided by Commission rule 15c3–1. 2L. Loss, *supra* note 1 at 1353 n. 246. See also H. Baruch, Wall Street Security Risk 176 (1971). On Aug. 1, 1971 the ratio was again changed to 15:1. 1 Study of the Securities Industry, Hearings Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce, 92d Cong., 1st Sess. at 202–275 (1971 [hereinafter cited as "House Hearings"].

[17] See *e.g.* 1 House Hearings at 53.

[18] 1 Special Study 408–409 (1963); 5 L. Loss, *supra* note 1 at 3420.

[19] *Id.* And see 1 House Hearings 53.

[20] *E.g.* 2 House Hearings 915; Guy D. Marianette, 11 S.E.C. 967 (1942).

[21] *E.g.* 2 House Hearings 909.

[22] Letter from Robert W. Haack to Irving M. Pollack, Director, Division of Trading & Markets, Securities & Exchange Commission, May 25, 1970, pp. 13–14. The operating cycle concept was not used by the NYSE, however, due in part to Commission resistance.

themselves during the period covered by the case study were based upon plausible policy considerations and not merely upon a rule of necessity promulgated at a time of tremendous stress.

II. PARTIAL CHRONOLOGY OF THE FINANCIAL CRISIS

A. NYSE Net Capital Rule and Special Trust Fund

Over the years the New York Stock Exchange has taken great pride in the financial responsibility of its members. Until 1963, for example, the Exchange's annual *Fact Book* contained an extensive table comparing the solvency record of NYSE member organizations with that of banks from the turn of the century on.[23] The Exchange also measured the success of its financial responsibility program in terms of the impact on customers and was able to state in April of 1970 that:

> . . . no customer of a member organization of the New York Stock Exchange in more than 30 years has sustained a loss of securities or funds as the result of a failure of an NYSE member firm. This is a record of which the exchange is proud and one which we expect to continue unblemished.[24]

The Exchange has viewed its net capital rule as being of fundamental importance in assuring the financial responsibility of member organizations. In 1963 the Special Study of the Securities Markets reported that "the net capital rule . . . is regarded by the Exchange as the most important rule administered by the department of member firms."[25]

Until 1963 the Commission had no formal inspection program for the securities exchanges and the Commission does not know whether there were any net capital inspections of the New York Stock Exchange prior to that time. A net capital inspection was conducted, however, in the course of the Special Study and the results were very complimentary of the Exchange:

> The enforcement by the Exchange of its net capital rule should be the standard by which other aspects of its regulatory program are judged. The staff vigorously seeks out violations and they are processed swiftly and fairly.[26]

In 1963 the Commission's Division of Trading and Markets did develop a plan for a program of continuous and comprehensive inspection of the NYSE's performance of its various self-regulatory responsibilities. Consistent with the Special Study's analysis, the Division determined to deemphasize the NYSE's net capital enforcement in making its inspections: "Areas such as enforcement of the Exchange's net capital rule, which the Exchange has shown itself to have handled with diligence and efficiency, will be left alone or given a very quick inspection."

Thus, at the end of 1963 the New York Stock Exchange and its member organizations had established an admirable record of financial responsibility. The Exchange's net capital enforcement pro-

[23] See, *e.g.*, New York Stock Exchange, Fact Book, p. 37 (1962).
[24] Federal Broker-Dealer Insurance Corporation, Hearings Before the Subcom. on Securities of the Senate Comm. on Banking & Currency, 91st Cong., 2d Sess. at 176 (1970).
[25] 4 Special Study 526 (1963).
[26] 4 Special Study 527 (1963).

gram had been found by the Commission to be a model of self-regulation. At about the same time the Exchange, moved by the failure of one of its most respected old line member firms, took additional steps to protect public customers from brokerage failure.

The failure of Ira Haupt & Company led to the subsequent establishment by the Exchange of a Special Trust Fund for the protection of public customers of insolvent member firms. The Exchange may ultimately expend over $100,000,000 of Trust and other funds to protect customers of failing member organizations.[27]

In November of 1963 Ira Haupt & Company became insolvent when one of its customers was unable to meet margin calls on commodities (salad oil) contracts. The failure of Ira Haupt & Company placed in jeopardy the firm's 20,700 customer accounts aggregating millions of dollars in cash and securities.[28] To meet the emergency and to maintain investor confidence, the Exchange's Board of Governors voted to assess the membership up to $12,000,000 in connection with the Haupt liquidation. Of this amount $9,500,000 was actually used to assist in the liquidation.[29]

Shortly after the Haupt liquidation the Exchange membership established a $25,000,000 Special Trust Fund to protect customers of member organizations which might fail in the future.[30] The size of the Customer Assistance Program has been increased from time to time as needed and in 1971 the ceiling was raised to $140,000,000.[31]

The trustees of the Fund are the directors of the Exchange. They are authorized to use the fund—

> for the purpose of providing direct or indirect assistance to customers of a member [organization] . . . threatened with loss of their money or securities because such member [organization] . . . is insolvent or is in such financial condition that . . . it may be unable without assistance to meet . . . its obligations to such customers, *but only to such extent, if any, and in such manner, as the Trustees shall determine.* (Emphasis added.)

The Deed of Trust, which was signed on July 30, 1964, goes on to provide that:

> FIFTH: No . . . person shall in any event have any claim or right of action . . . against the Exchange, the Trustees, or any other person, or against the Fund, as a result of any action taken or the failure to act by the Trustees in the exercise of their discretion. Whether or not expenditures from the Fund shall be made in a case involving a particular member [organization] . . . and, if so, in what manner, to whom and to what extent, shall at all times remain exclusively within the sole and absolute discretion of the Trustees.

With the establishment of the Special Trust Fund the Exchange appeared to have strengthened its already strong program for assuring member financial responsibility.

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[27] See, *e.g.* New York Stock Exchange, Inc., Annual Report for the Year Ended December 31, 1971, p. 35 (1972).
[28] See N. Miller, the Great Salad Oil Swindle 10 (1965).
[29] *Id.* at 232. See also H. Baruch, Wall Street: Security Risk 213–214 (1971).
(1971).
[30] *Id.*
[31] New York Stock Exchange, Inc. *supra* note 27.

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B. Commission's 1964 Net Capital Inspection

Between February 10 and 13, 1964 the Commission's Division of Trading and Markets conducted an inspection of the NYSE's "treatment of matters relating to financial responsibility." Three Commission employees spent four days examining Exchange files and those of six member organizations in connection with the inspection. The inspection report concluded as follows:

> Our inspection indicated that the Special Study's assessment of the Exchange's performance—that it should be the standard by which its other self-regulatory functions are judged—is on the whole an accurate one. Nevertheless, certain weaknesses in procedures were noted which should be corrected.

Among the weaknesses pointed out in the inspection report was the following:

> While [the practice of assigning greater haircuts to securities of questionable marketability] . . . is very salutory and is effectively performed, the Exchange appears to be more lenient where an increased haircut will create a capital deficit. The Exchange should reverse this leniency since a security which has only limited marketability is more dangerous to the poorly capitalized firm than to the well-capitalized firms.

The staff's concern over the Exchange's apparent policy of loosely interpreting the net capital rule where necessary to keep firms in ostensible compliance was communicated to the Exchange in a meeting held April 1, 1964. The Commission's record of the meeting recites:

> The staff mentioned that the Exchange staff appeared more lenient in taking a higher haircut on proprietary securities (following a marketability study) when the firm would be out of ratio. Jones said this was completely unintentional and that in fact he tried to be more severe. He agreed to look into it.

The Commission's files contain no further reference to this problem. In fact, for the next several years there is very little in the files regarding the NYSE's enforcement of its net capital rules. After 1964 the Commission did not conduct another formal net capital inspection of the Exchange until January of 1970 although the staff was in frequent informal contact with the Exchange.[32] In the 1970 inspection report the Commission's staff expressed the view that, going back as far as 1968 (the period covered by the inspection), the Exchange had been too lenient in imposing sanctions for violation of rule 325. By this time, however, the securities industry was in the midst of the worst financial and operational crisis it has ever experenced.

C. Beginnings of Financial Crisis

Although the events of the period 1964–1968 are somewhat unclear, it is known that the capital problems of the late 1960's were related to a tremendous upsurge in trading volume and the ensuing paperwork crisis experienced by brokers. Beginning about 1967 share volume on

[32] See Chronology, Exhibit A.

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the NYSE spurted to unprecedented levels. In order to take maximum advantage of the exceptional growth and volume, firms expanded as quickly as possible, often without recognizing the potential strain on their financial position and with little regard for their ability to process transactions. As the paperwork began to back up, record discrepancies and mushrooming "fails" (failures to deliver or receive securities on settlement date) placed heavy burdens on firms' net capital.[33] More and more firms experienced difficulty complying with applicable capital rules. Some were required to liquidate. Others were forced to merge. When the dust cleared in 1971 over 100 member organizations had vanished from the NYSE's roster and an unknown number of nonmember firms had also disappeared.

Pickard & Company, Incorporated. The first NYSE member organization to fail during the operational crisis was Pickard & Company, Incorporated.[34] The appointment of a liquidator for the company on May 20, 1968 climaxed a history of numerous serious rule violations including recurring net capital problems. The Exchange became aware of the first violation when the firm's capital ratio was computed to be 2710% as of April 30, 1965 and 2642% as of June 30, 1965. The Exchange censured the firm for this violation and directed the firm to maintain a ratio of below 1500%. One year later, June 30, 1966, the firm's ratio was found to be 2532%. The Exchange censured the firm and fined it $5,000 for this and other violations. On June 30, 1966 the Exchange also restricted Pickard from—

> hiring any additional salesmen; opening new branch offices; trading in excess of $100,000 for the firm account, accepting any new margin accounts with significant debit balances; engaging in underwriting; and effecting any new transactions for the conversion account, in addition to the prior restriction imposed on Pickard in 1965 requiring it to maintain a net capital ratio of 1,500 percent.[35]

In addition to the above capital computations, most of which were made by the NYSE, it is now known that the firm in some instances attempted to conceal its true net capital position by withholding bills from the firm and changing from an accrual to a cash basis of accounting.[36]

The chronic record-keeping and capital problems of the Pickard firm began to heat up in late 1967 and early 1968. In December and January the firm's auditors notified the Exchange that they were having difficulty completing the audit and that they would be unable to express an opinion on its financial statements as of September 30,

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[33] Securities Industry Study, Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs for the Period Ended February 4, 1972, 92d Cong., 2d Sess. at 7–11 (1972). Fails to receive are included among the items of "aggregate indebtedness" and must be supported by the firms "net capital." Securities which the broker-dealer has failed to deliver to another party ("fails to deliver") beyond 30 days after settlement date are subject to the "haircut" povisions of applicable net capital rules and therefore can also have a negative effect on the broker-dealer's net capital position.

[34] For a fuller description of the affairs of Pickard & Company, Incorporated see Staff of Special Subcomm. on Investigations of House Comm. on Interstate & Foreign Commerce, 92d Cong., 1st Sess., Review of SEC Records of the Demise of Selected Broker-Dealers 136–140 (Subcomm. Print 1971) [hereinafter cited as "Demise"].

[35] Demise at 138. However, subsequent inspections by NYSE and the Commission revealed that the firm had violated many of the restrictions imposed upon it by the NYSE and employed a number of devices designed to circumvent the imposed restrictions.

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1967. Other problems persisted and in February the Exchange dispatched at least 20 of its own employees to Pickard in an attempt to clear up "back office" problems.

The Commission commenced a private investigative proceeding into Pickard's affairs in February of 1968 when its New York Regional Office discovered in an unrelated investigation that it was impossible to obtain trading information from the firm because of the confused state of its records.[37] On February 23, 1968 Pickard advised all of its registered representatives to seek other employment and on May 20 the Exchange appointed a liquidator.[38] Although the firm was relatively small by NYSE standards, 30 Exchange employees worked for more than 18 months in resolving Pickard's record discrepancies.[39]

Commitment of Special Trust Fund. As Pickard's problems deepened, the Commission sought to obtain from the NYSE a commitment that the Exchange would use its Special Trust Fund to protect Pickard's public customers should the firm fail. The Exchange, on the other hand, delayed such a commitment because it felt the need had not been demonstrated and because of the discretionary nature of the Fund. The correspondence between the Commission and the Exchange on this subject formed a pattern which was to recur throughout the financial crisis of the late 1960's.

On February 28, 1968 the Director of the Division of Trading and Markets wrote to Mr. Haack, President of the Exchange expressing the Commission's concern about Pickard and stating: ". . . in order to consider what action it should take in this matter, the Commission would like to know . . . the nature of the Exchange's commitment with respect to those obligations, if any, that the firm is unable to meet."[40]

The Exchange replied on March 1, 1968 stating in part:

> The Exchange is not aware that the firm has failed to meet its obligations other than their slowness in paying bills and delivering out accounts.
>
> However, we have not reached a conclusion that the firm is insolvent and it has sufficient cash on hand to permit the operations that appear necessary in the near future for withdrawing securities from bank loans and delivering out customer accounts. Consequently, the Exchange has not made any commitment to meet any obligations which the firm may not be able to meet: the reason being that we do not yet know that there are any obligations which the firm cannot meet.[41]

The Director of the Division of Trading and Markets wrote again on March 14, apparently trying to "jockey" the Exchange into some sort of a commitment to the 3,500 Pickard customers:

> I have your letter of March 1, 1968 concerning Pickard & Company. While I understand that at this time no determination has been made with respect to solvency, you have directed Pickard to cease all activities other than those neces-

[37] See note 34 *supra.*
[38] Letter from Robert M. Bishop to Irving M. Pollack (March 1, 1968).
[39] New York Stock Exchange Special Membership Bulletin (October 1970).
[40] Letter from Irving M. Pollack to Robert W. Haack (February 28, 1968).
[41] Letter from Robert W. Haack to Irving M. Pollack (March 1, 1968).

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sary to complete an orderly liquidation. As I explained in our telephone conversation last week, the Commission is most concerned with the precarious condition of Pickard's affairs and accordingly desires to know the Exchange's position in the event the firm is unable to meet its obligations.

I understand that if necessary the staff of the Exchange would recommend to the trustees of the Special Trust Fund that with the exception of the firm's subordinated lenders, the trustees undertake to fully discharge all of the firm's obligations to its customers. I assume that in such event the Exchange staff also would recommend the appointment of an Exchange liquidator.

If there is any change in this position or if we can be of any assistance, please let me know.[42]

Although the Commission's files contain no response to the Director's letter, ultimately the NYSE did commit its Special Trust Fund to the Pickard customers. A total of $407,000 was expended of which all but $169,000 has been recovered by the Exchange.[43]

D. Dealing With the Crisis: 1968

The Pickard failure was only one manifestation of the financial and operational crisis which, by the spring of 1968, was beginning to engulf the entire securities industry. To help stem the problem the Commission and the Exchange instituted a campaign of inspection of every major firm in the United States. As a result of those inspections restrictions were imposed on the business of firms having operational difficulties. Some 30 measures were put into effect ranging from Wednesday market closing to restrictions on the business of problem firms.[44] Examples of the restrictions placed upon member organizations by the Exchange included: no new sales offices, no increase in the number of registered representatives, no firm trading, no solicitation of margin accounts, no underwriting, special (weekly) reporting and restriction to a certain number of trades per day or week. In terms of the number of organizations subject to restrictions at any one time, the Pickard failure came near the high point. In June of 1968 there were 47 NYSE firms subject to restriction. By September of 1969 the total was 28. Three months later there were 12.[45] Of course, as time wore on, the *gravity* of the problems increased. The potential consequences of failure of one or more of the largest firms in 1970 were astronomical.

Proposed Increase in Special Trust Fund. As conditions worsened the Commission stepped up its efforts to keep abreast of developments in the industry[46] and urged the Exchange to take steps to strengthen its ability to protect public customers. On July 2, 1968 the Director of the Commission's Division of Trading and Markets wrote to the Exchange suggesting an increase in the Special Trust Fund. Mr. Haack, President of the Exchange, responded, in part, as follows:

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[42] Letter from Irving M. Pollack to Robert M. Bishop (March 14, 1968).
[43] New York Stock Exchange, Annual Report for the Year Ended December 31, 1968, p. 16; H. Baruch, Wall Street: Security Risk 191 (1971).
[44] New York Stock Exchange, Special Membership Bulletin (October 1970).
[45] *Id.*
[46] 1 House Hearings 55 (1971).

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> First, we would like to make clear for the record that the Special Trust Fund is a discretionary program.
>
> In selecting an eventual goal of $25,000,000 for the Special Trust Fund program, the high-level Special Committee of the Board which recommended the program to the Board and to the membership did so on the basis that Haupt had been the largest debacle in the history of the Exchange; that $12,000,000 was then the outside estimate of what it might cost to bail out the customers of Haupt; and that the availability of a sum twice that amount for possible use in a future case or cases should be a long-range goal, having in mind future growth of the Exchange community.
>
> From time to time over the last several years, the staff of the Exchange has considered whether it would be desirable to recommend additional contributions to the Special Trust Fund or enlargement of the overall program . . . the conclusion has been made that the same considerations that led to the original decision . . . seemed, on review, to be still valid.[47]

Although the Commission continued to pressure the Exchange, it took no formal action to obtain an increase in the Special Trust Fund. As conditions worsened during the following months, the NYSE did increase the Fund and, at December 31, 1971, had expended nearly $85,000,000 to directly or indirectly protect customers of members and was committed to expend further amounts up to $45,000,000.

Current Information on Members.--Another step taken by the Commission in attempting to deal with the burgeoning financial crisis was to request the Exchange to furnish the Commission with current information on the financial condition of member organizations. As stated, in May of 1968 the Commission and the exchanges determined to inspect every major firm in the United States. In July of 1968 the Director of the Division of Trading and Markets wrote to Mr. Haack suggesting cooperative efforts in regulation:

> . . . the Exchange would advise us of information developed in the course of an inspection or inquiry which indicates (1) problems with regard to the soundness of the financial condition or net capital position of any member organization or (2) possible misappropriation of customers' funds or securities, unregistered distribution, fraud or other serious misconduct on the part of a member firm or an associated person.[48]

In his reply, Mr. Haack stated in part as follows:

> There is a further problem in reporting to you earlier than at present with questions of finance and serious misconduct. This is in defining at what point a question becomes a fact. For example, fairly frequently an examiner, as a result of a visit or questionnaire analysis, will report a possible capital violation, which after investigation will prove not to be a violation because of reporting errors causing incomplete understanding between the Exchange, the member firm and sometimes its auditors.

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> We doubt that the time of your staff should be occupied with possible duplication of worry, inquiry, and responsibility in the same such matters to which our staff is giving attention.
>
> There is also an important matter of morale of our staff in such matters. On such matters reported to you, you will have a responsibility at least for consultation with our staff. We have the feeling that this will lead to a deterioration in the sense of responsibility for corrective action and decision by our staff members who today are delegated such authority by our Board and officers.[49]

However, the Division of Trading and Markets renewed its request on October 1, 1968:

> 2. With regard to the reporting to us of suspected capital violations, you refer to the case where a possible violation is reported but due to errors or misunderstandings it is discovered that no violation in fact occurred. Here I believe it would be an easy matter for your staff to advise us of such a change in its opinion. I might point out that we have for many years worked rather successfully with the NASD in the capital area. Indeed, the NASD has had a few instances where reports have been made to us which later had to be modified based on circumstances such as you suggest.
>
> 3. You state that you doubt that the time of our staff "should be occupied with the possible duplication of worry, inquiry, and responsibility in the same such matters to which our staff is giving attention." In our view, any such duplication is far outweighed by the advantages to be gained by early interchanges of information, particularly the real possibility that your members may be relieved of burdens imposed on them (unwittingly) by unnecessary duplication of regulatory efforts.
>
> 4. With respect to the matter of the morale of your staff, I should emphasize that a basic motivation for our proposing broader programs of cooperation is to enable us to place greater initiative and responsibility in the established self-regulatory processes. We think that in the long run this would substantially increase morale.[50]

The question of degree to which the Commission should have access to information developed by the NYSE about the financial condition of NYSE member organizations was not resolved in the above-quoted correspondence. In fact, that question pervaded the entire financial crisis and is treated in greater detail in a separate section of this case study.[51]

Enforcement Problems.—During the balance of 1968 some NYSE member firms continued to experience net capital problems and enforcement problems began to materalize. After its January, 1970 net capital inspection, for example, the staff reported to the Commission that, although there were 16 member firms which violated the net

[49] Letter from Robert W. Haack to Irving M. Pollack (August 7, 1968).
[50] Letter from Irving M. Pollack to Robert W. Haack p. 2 (October 1, 1968).
[51] See pp. 362–368 *infra*.

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capital rule at least once during 1968, only one net capital disciplinary proceeding had been reported to the Commission and only 6 of the firms had been the subject of Advisory Committee disciplinary actions during the following year. The Exchange asserts that review of its files indicates that it did take disciplinary action against one of these firms and that the remainder were cases where the firms did not in fact violate the Exchange capital rule. The Exchange says that while preliminary analysis of audited questionnaires indicated apparent violations, the firms or their auditors, when this was brought to their attention, were able to supply the Exchange with the necessary facts to show that the firms were not in violation.

Commission examiners also reported to the Commission two instances in which Regular Financial Questionnaires filed by member organizations, interpreted under existing Exchange policies, would have revealed net capital violations. However, the staff reported, the net capital ratios were not computed in accordance with established policies and the firms were not disciplined. As to these two cases, however, the Exchange maintains that such was not the case. The Exchange states that the two firms would only have been found to be in violation had the Exchange charged their sizable short stock record bookkeeping differences, which was not its practice at the time.

In Chairman Cohen's letter of December 9, 1968 to Mr. Haack concerning the industry's "back-office" problem, he stated:

> Among the matters which have been presented as having a substantial potential for improving the situation are the following measures which could be adopted promptly by the Exchange:
>
> * * * * * *
>
> (3) *Firm application of the Exchange's net capital rules (with all applicable charges)*, and "buy-in" rules. (Emphasis added.)

As 1968 drew to a close the Commission was becoming impatient with the industry's failure to remedy the so-called "back office" problem. During the year fails of NYSE member firms alone (including over-the-counter trades) had increased from $2.7 billion in January to $4.1 billion in December.[52] The Commission expressed its concern to the Exchange in strong terms in a meeting on November 4, 1968.[53]

Three days after this meeting the Exchange furnished, at the Commission's request, a detailed status report listing the steps the industry was taking to monitor and deal with its problems. In this report the Exchange revealed to the Commission that some 46 member organizations were then in operations restrictions. Among the 25 organizations doing the largest NYSE commission business, five were on restriction. A total of seven organizations (including one from among the top 25) were considered critical by the Exchange staff.[54]

NYSE Constitutional Amendments.—Prior to December 1968 Article XIII of the Exchange Constitution authorized the Board of Governors to suspend a member organization only if it found that the

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[52] Securities Industry Study, *supra* note 41 at 10.
[53] New York Stock Exchange, Memorandum from R. John Cunningham to Lee D. Arning (November 6, 1968).
[54] Letter from R. John Cunningham to Hon. Manuel F. Cohen pp. 5-6 (November 7, 1968).

organization had failed to meet its engagements, was insolvent or was in such financial condition that it could not be permitted to continue in business with safety to its creditors or the Exchange. In order to permit suspension in those cases where operational problems warranted suspension, though it could not be shown that the member organization was in or was bordering on "insolvency", the Exchange on December 23, 1968 amended Article XIII of its Constitution to authorize the Board to suspend a member organization found to be in such *operating* condition that it could not be permitted to continue in business with safety to its creditors or the Exchange.[55] In support of the proposed amendments, which became effective on January 30, 1969, the Exchange stated:

> The amendments would also give the Board the authority to suspend summarily a member organization whose operations were in such condition that it should not be permitted to continue in business with safety to its creditors or the Exchange. This is being done in recognition of the need to be able to act quickly in situations such as that which occurred in connection with Pickard & Co., Inc.

As the financial crisis wore on, interpretation of the provision governing suspension of member organizations was to become a bone of contention between the Exchange and the Commission with the Commission favoring decisive Exchange action and the Exchange taking the position that its Constitution and Rules did not permit immediate suspension of a member firm simply because of a net capital deficiency.[56]

Increased NYSE Surveillance.—The procedures outlined in the Exchange's letter of November 7, 1968 to Chairman Cohen [57] for monitoring the financial and operational condition of member organizations were adopted in part out of concern for the reliability of information on the financial status of members. This concern led to the development of a special operations questionnaire in the spring of 1968 and to the reorganization of the Exchange's Department of Member Firms and appointment of six Exchange "coordinators" to provide added surveillance. The source of the problem was, in part, the inherent unreliability of information furnished by the member organizations themselves. Frequently those firms having the worst financial problems also had the worst books and records. Furthermore, members had little incentive to promptly notify the Exchange of possible net capital violations which might result in suspension, expulsion or other sanctions.

Thus, from 1968 on, the NYSE and the Commission were continually trying to improve the amount and quality of available information regarding the financial condition of member organizations. Throughout the period the Exchange maintained confidence in its ability to monitor and police the financial condition of its members.

E. Dealing With the Crisis: 1969–1970.

In 1969 the gravity of NYSE members' financial problems increased. Although fewer organizations were involved, the potential demands

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[55] The amendment provided that a member might be suspended for insolvency upon a finding that the member had "failed to meet its engagements," was "insolvent" or was "in such financial or operating condition that it cannot be permitted to continue in business with safety to its creditors or the Exchange."

[56] Letter from Robert W. Haack to Hon. Hamer H. Budge p. 6. (October 23, 1970). And see text at p. 353, *infra*.

[57] See text *supra* at p. 54.

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on the Special Trust Fund grew by leaps and bounds.[58] By 1969 the Commission was aware that the "back office" problem had become a financial crisis of profound dimensions.[59] On January 29, 1969 the Exchange, pursuant to its established practice, sent the Commission its current list of firms on restrictions. Thirty-five organizations were listed.

Surveillance.—On July 16, 1969 Chairman Budge of the Commission requested the Exchange to report on its programs for checking on the financial condition of member organizations. The Exchange responded: "The Exchange's programs are relatively extensive in this area." It then detailed the surveillance programs of the Exchange and concluded: "We feel that further measures are not necessary at this time." [60]

In response to another request from the Commission for information on its surveillance of the financial condition of member organizations, the Exchange responded on September 23, 1969 that 16 firms were having financial difficulty but that "this does not imply that these firms have violated our capital requirements but that we are concerned with their capital condition and profitability. These firms have all been contacted within recent weeks to improve their capital position * * *." [61] The Exchange did not mention in its letter that at least two of the firms on the list had recently had net capital violations.[62] Nine of the 16 organizations mentioned in the letter were eventually either liquidated or forced to merge with other organizations. Two commenced liquidation within a month at an estimated eventual cost to the Special Trust Fund of over $7 million.[63]

Commitment of Special Trust Fund.—Throughout the summer of 1969 the financial condition of member firms deteriorated concurrently with the decline in the market. In response, the Commission involved itself more directly in dealing with the financial crisis.[64] As it had done in connection with the Pickard liquidation,[65] the Commission sought to obtain early commitments of the Special Trust Fund from the Exchange as to each failing firm. Consistent with its own position in the Pickard matter, however, the Exchange responded that the Special Trust Fund was discretionary in nature and that it would be premature to commit the Fund before determining whether any expenditures would actually be necessary. In the first such case, that involving Dempsey-Tegeler & Co., Inc., the Exchange added: "The Trustees have always required that any expenditure of trust funds cease immediately upon the institution of any bankruptcy proceeding by or against the firm or upon the institution of any legal proceeding looking toward the appointment of a receiver." [66] This same general colloquy between the Exchange and the Commission recurred over the following months with regard to other failing member firms.[67] The Exchange's decision not to commit the Special Trust Fund until liquidation had commenced and, even then, to withhold all funds in the

[58] See *e.g.* Unsafe & Unsound Practices Report at 209, fn. 16, 211, fn. 21.
[59] See, *e.g.* 1 House Hearings at 56.
[60] Letter from Lee D. Arning to Hamer H. Budge (July 25, 1969).
[61] Letter from Robert W. Haack to Hon. Hamer H. Budge p. 2 (September 23, 1969).
[62] *E.g.* Demise at 57, 101.
[63] *Id.* at 51, 102. See also SEC, Study of Unsafe & Unsound Practices of Brokers & Dealers, 92d Cong., 1st Sess., H. Doc. 92-231, p. 209, fn.16 (1971) [hereafter cited as "Unsafe—Unsound Practices Report".]
[64] See, *e.g.* 1 House Hearings at 56.
[65] See text *supra* at p. 239.
[66] Unsafe & Unsound Practices Report at 208.
[67] *Id.*

event of bankruptcy or other receivership proceedings appears to have made the Commission reluctant to "move in" on member organizations until all possibility of use of the Special Trust Fund had been exhausted.[68]

Enforcement Problems.—The Commission indicated in its Unsafe and Unsound Practices Report that, as the financial crisis became more and more serious, the Exchange relaxed its standards of compliance with applicable net capital and recordkeeping rules because the Exchange believed that immediate enforcement would increase the danger to public customers.[69] The Exchange believes that at all times during the financial crisis it interpreted its net capital rule in a fair and evenhanded manner and that it enforced its rules responsibly under all of the circumstances.

In late 1969 and early 1970 the Commission's staff reported several conversations with NYSE officers concerning the Exchange's enforcement of its net capital rule.

For example, on December 11, 1969 the staff reported that an Exchange officer, speaking for himself and not the Board of Governors, had confided as follows:

> He stated that the Stock Exchange staff was under great pressure to interpret the rule as loosely as possible, so that firms would not be deemed in violation of the rule. He further stated that once public ownership was approved and put into effect for member firms, the staff would shift their position 180 degrees on the interpretation of the Exchange's net capital rule.[70]

In a conference on January 19, 1970 an Exchange officer reportedly stated that so many NYSE members had capital problems that in enforcing the capital rule you have to

> "Start living dangerously." He said that it was extremely important to do everything possible to keep a firm in business because of the potential harm to customers when a firm was forced out of business. [He] * * * said that although the Exchange's rule is at 2000%, in the past the Exchange has always administered the rule as if it were a 1500% rule. [He] * * * said that the Exchange simply cannot administer the rule in that fashion any more because of the large number of firms that are close to 1500% or exceed it.

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[68] See, *e.g.* Unsafe & Unsound Practices Report at 23; H. Baruch, Wall Street: Security Risk 209 (1971). But see 3 House Hearings at 1619:

> Mr. Sporkin. I am familiar with it, Mr. Chairman, and the point is that I think that if you saw how we operated in the critical period and understand what we did, I think you would find that the way we operated was equitable, was fair across the board.
>
> I give you one example, we made it quite clear when it came to the net capital problems that New York Stock Exchange members were having at the time, we went to the New York Stock Exchange and we said:
>
> > Look, under our computation, they are out of balance. You have a choice here. Either they come into balance or, in effect, you are going to commit your trust fund monies.
>
> We said further that, "If you do not commit trust fund moneys, we are going to move in," and I think if you examine that record, you will find that, in every instance, the exchange committed its money; in every instance that we did not act, they committed their moneys; and those instances where they did not commit their moneys, I think it was in 7 days we were in court—the cases were Robinson & Co., First Devonshire, and Charles Plohn & Co.

[69] Unsafe & Unsound Practices Report at 207.

[70] The Exchange official purported to have made this statement denies that his comments are accurately reflected in the staff report.

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On April 21, 1970, pursuant to an invitation from Commissioner Owens, the top management of the Exchange met with the Commission and its staff. The Commission's memorandum of the meeting includes the following statements:

> [A] Commissioner * * * questioned the New York Stock Exchange officials about the consistency of their interpretations of their net capital rule, particularly in view of their testimony before Congress that their rule was stricter than the Commission's. He suggested that it might help in dealing with troubled firms if everybody knew the truth about their condition and, to that end, he suggested that a firm and consistent application of the Rule would be best. In reply, Mr. Haack stated, "If we had been absolutely literal we probably would have had half of Wall Street out of business."
>
> * * * * * * *
>
> With respect to the concern expressed by Commissioner Smith * * * about the "quality" of the capital which had been infused into Dempsey-Tegeler and Hayden, Stone, Mr. Haack stated, "Beggars can't be choosers. We have had to do things to be expedient or put the firms in the red."

The Commission's staff reported to the Commission that, when the Exchange decided to allow member organizations to continue in business despite their capital problems, it did not merely grant them a special dispensation. Rather, the Exchange, according to the Commission's staff, *interpreted* the rule in such a way as to allow firms not only to continue in business, but to remain in seeming compliance with the rule.[11] For example, the following passage appears in a Commission Memorandum summarizing the net capital inspection of the NYSE begun January 26, 1970:

> In the past, the Exchange, as a matter of policy, followed the Commission's treatment [of short stock record differences]. However, without notifying the Commission, the Exchange changed its policy in May 1969 so as not to charge its members' capital with this item. The Exchange staff at the time of the inspection advised that the reason for this change was that a continuation of the old policy would result in numerous violations of its net capital rule."[12]

On April 28, 1970, after reviewing the staff's report of the NYSE net capital inspection conducted in January and February of 1970, the Commission authorized its staff to direct a letter to the Exchange stating, among other things:

> Attached you will find a summary of findings made by the staff of the Commission as to the application and interpreta-

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[11] The procedure followed by the NYSE in "working out" details with a member and arriving at a definitive computation is described in the Unsafe & Unsound Practices Report at p. 103.

[12] The Exchange maintains that there was no policy change in 1969 and that the SEC was fully aware of the Exchange's treatment of bookkeeping differences as far back as 1966. The Exchange's description of its treatment of short stock record differences is found at Exhibit C.

An additional reason for the Commission's concern about the treatment of short stock record differences was that, unless charged against net capital, the member organization had little incentive to research such differences and eliminate them.

tion made by the Exchange of its net capital rule (Rule 325). These findings raise grave doubts in the minds of the staff as to the retention of the present exemption to the Commission's net capital rule now enjoyed by the Exchange.

Since the financial condition of member firms has become a source of grave concern to the Commission, we believe that immediate steps must be taken by the Board of Governors of the Exchange to rectify the improper practices which have crept into the application of the Exchange's net capital rule.[73]

And, two days later the Commission authorized another admonition to the Exchange:

> Consideration was given to a memorandum dated April 27, 1970 from the Division of Trading and Markets with respect to the New York Stock Exchange, in particular the Exchange's treatment of "short stock record differences and reserves for such differences" in the computation of a member firm's net capital. The Commission approved an attached draft of a proposed letter from the Division to the Exchange advising that the Division could see no basis for granting relief from a strict interpretation of the appropriate net capital [sic] to Hayden, Stone & Co., Dempsey, Tegeler & Co., or any other firm experiencing financial or operational difficulties, at least in the absence of an Exchange guarantee of the firm's financial responsibility. Accordingly, the letter urged that the two firms be advised immediately to take steps to come into compliance promptly with the applicable requirements."

The Exchange replied to the Commission's letter of April 29, 1970 with a detailed analysis of its own program of financial responsibility for member organizations. In an apparent reference to its policy of interpretation of rule 325, it stated:

> As noted above there is a high degree of interdependence among members of the Exchange community which results from the contractual relationship among the Exchange, Stock Clearing Corporation and Members and Member Organizations. Not only must the Exchange be concerned with the solvency and liquidity of individual members but it must also be concerned with the overall liquidity of the market place. Responsible administration of Rule 325 demands due consideration of the impact of remedial action with respect to one member organization upon the wider circle of other brokers and their customers etc. A very significant benefit accrues to the entire community from the exercise of sound judgment by the administrative arms of the New York Stock Exchange. Unhappily there has been a tendency for the discretion, responsibly exercised, to become confused with the interpretation of the specific text of statutes, regulations and rules. This process is not unique to the Exchange as is illustrated by your interpretation in support of haircuts on commercial paper. I believe that it will be very useful if

[73] Letter from Irving M. Pollack to Robert W. Haack (April 29, 1970).

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members of our respective staffs can cooperatively study (among other things) the proper boundaries of the two distinct processes: interpretation and responsible exercise of discretion.[74]

The Commission's files do not reveal what response, if any, was made to Mr. Haack's letter of May 25, 1970. But, in any event, the Commission did not do what it had suggested in its April 29 letter—*viz.* withdraw the Exchange's exemption from Rule 15c3–1.

In June of 1970 the Commission's staff received what it described as a "thorough briefing" from an officer of the Exchange. In addition to certain specific information, the staff gained the following impressions:

1. Financial problems are more widespread than we have previously realized. A considerable number of NYSE member firms, including some substantial ones, have been in net capital violation, this year and/or last year, and many other (sic) have had ratios over 1500%.

2. These problems, as of now, are still of manageable proportions. The Exchange has been largely successful in pressuring troubled firms to raise more capital or to join with stronger organizations. Cost cutting programs have been urged for many firms.

3. The Exchange is quite apprehensive about the future because there is no end in sight to the crisis. In addition to the understandable reluctance to shut down any member, there is the fact that the Exchange cannot afford to stand behind all of the members that are in net capital violation now, let alone those that might become so in the future. Consequently, the Exchange cannot and will not enforce compliance with its net capital rule.

4. There is a feeling that some firms, e.g., Hayden, Stone, may be too big to regulate. In other words, they may be achieving quasi-utility status, whereby the public interest requires their continuation despite their deficiencies.[75]

In July, however, another NYSE officer gave a very contrary impression in a national magazine article:

Before this year, a firm was required to keep its ratio of net indebtedness to liquid capital below 15:1, which was the exchange's early warning mark. (At 20:1, a firm would be forced out of business "in a matter of hours," says Arning, implying that he does not allow a firm's ratio to get even that high.) But in the first quarter (sic) this year, the Big Board toughened the rule; the ratio, it said, had to be under 12:1, and operating losses for a month could not exceed 15% of excess capital. If capital was the problem, the firm usually was allowed no more than a week or two to get it in line. The grace period was longer for operating prerogatives [for corrective action] are management's," says Arning.[76]

[74] Letter from Robert W. Haack to Irving M. Pollack p. 3 (May 25, 1970).
[75] The Exchange official purported to have done the briefing denies that his comments are accurately reflected in the staff's reported impressions.
[76] Business Week, July 18, 1970, p. 112.

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On August 11, 1970 an informal meeting was held among NYSE and Commission staff members to discuss possible revision of NYSE rule 325. According to the Commission memorandum of the meeting:

> The NYSE representatives indicated that the Exchange's Executive staff had been surprised at the differences between Rule 325 and the Commission's net capital rule emphasized in the report of the recent staff inspection. Consequently, the Exchange had been led to apply their net capital rule more consistently in recent months.

Early Warning System; First Devonshire Corporation; Goodbody & Co.—In its attempts to deal with the financial problems of member organizations, the NYSE developed what it called an early warning system in 1970. Through a series of financial questionaires and Exchange coordinators, the Exchange sought to closely monitor organizations in order to discover problems before they became unmanageable.[77] The Exchange had high hopes that the early warning system would enable it to deal with incipient problems more expeditiously.[78] However, subsequent events of 1970 made it clear that a surveillance program based solely upon the records of member organizations could not be relied upon to stave off massive brokerage failures.

During the summer of 1970 Congress had under consideration the Securities Investor Protection Act of 1970. In preparing a report to the Congress on the financial condition of Exchange members, Chairman Budge of the Commission asked the NYSE for advice as to the current status of member firms that might reasonably be expected to go into liquidation with potential losses within six to 12 months. He specifically inquired about a list of firms which the staff had advised were in varying degrees of financial difficulty.[79] The Exchange responded on August 12, 1970 that, except for three of the firms, it did not believe that any of the listed firms should reasonably be expected to go into liquidation. As to those three firms it expected that they could meet their obligations to deliver out customer accounts without Exchange assistance.[80] When the Exchange suspended First Devonshire Corporation (one of the firms *not* expected to liquidate) six days later, it became apparent that there were serious imperfections in the early warning system. And, when questioned by the Commission on October 16, 1970 about a reported $8 million capital deficiency at Goodbody & Co., a firm *not* on the Exchange's special surveillance list, the Exchange answered:

> The Commission's dismay was certainly no greater than ours when the preliminary results of the audit became available on October 15, which revealed that the audit's results were completely out of line with the firm's capital computations upon which we had been relying.[81]

It was not surprising, then, that the Chairman of the Exchange's Monitoring Committee wrote to Mr. Haack in October of 1970.

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[77] See, *e.g.*, Special Membership Bulletin, October 1970.
[78] See, *e.g.*, Federal Broker-Dealer Insurance Corporation, *supra* note 79 at 184. See also letter from Robert W. Haack to Hon. Hamer H. Budge (April 15, 1970).
[79] Letter from Hon. Hamer H. Budge to Robert W. Haack (August 7, 1970).
[80] Letter from R. John Cunningham to Hon. Hamer Budge p. 5 (August 12, 1970).
[81] Letter from Robert W. Haack to Hon. Hamer H. Budge (October 23, 1970).

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> I think the New York Stock Exchange should consider whether, in the light of this situation, it can really talk seriously about having an effective early warning system or whether entirely different procedures such as more frequent or possibly continuous auditing procedures of member firms should be studied. I am very uncomfortable with the idea that the Securities & Exchange Commission, the Congress and the public not be misled about what we can or cannot do in terms of early warning or monitoring, and I know that in this I speak for our full committee.[82]

October 1970 Net Capital Inspection.—Shortly after it learned of the net capital deficiency of Goodbody & Co., the Commission directed its staff to conduct an immediate inspection of the Exchange's early warning system and a further inspection of the Exchange's administration of its net capital rule.[83] This was the second net capital inspection of the Exchange in less than a year.

As a method of procedure the staff determined to prepare a series of 10 to 20 memoranda, each dealing with a single firm. The purpose of the memoranda, which were prepared during the following three months, was to allow the Commission to determine the "extent to which the Exchange knew of the problems of these firms and acted to force corrective measures." It is not necessary to deal in this case study with these individual firms on a case by case basis as that has been done adequately elsewhere.[84] However, it should be mentioned that these memoranda to the Commission tend to support the conclusion, stated in the Unsafe and Unsound Practices Report that the Exchange in some cases interpreted its net capital rule flexibility in order to avoid putting member organizations out of business. Our examinations of the files reveals that, although it made periodic remonstrances, the Commission did not terminate the Exchange's exemption from rule 15c3–1.

The NYSE interpretation of its enforcement policies was contained in a Special Membership Bulletin issued in October of 1970. The Exchange seemed to feel that its policies had been in the best interests of the financial community and its customers:

> *A question often asked is why did the Exchange allow a few major firms to continue in business despite critical paperwork and capital problems.* This was the case, for example, in 3 major firms, Dempsey-Tegeler & Co., Inc., McDonnell & Co., and Blair & Co., with a combined total of 165,000 customer accounts. In each case, the Exchange allowed continued operation under increased regulation, pending a scaling down of business and reduction of paperwork backlogs to manageable proportions.
>
> These were the key reasons for this approach:
>
> * * * *The severity of paperwork problems in these firms and the great number of customer accounts involved would not have allowed orderly liquidation had the firm been suspended.* Errors in stock records alone would have required many months, perhaps years, to resolve.

[82] 1 House Hearings 71.
[83] Letter from Hon. Hamer H. Budge to Robert W. Haack (October 16, 1970).
[84] See, *e.g.* Demise; Unsafe & Unsound Practices Report at 61–72, 95–122, 205–210.

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> * * * *Suspension could have emptied these firms of clerical staff at a time of intense competition among brokerage firms for skilled operations employees.* Demands of liquidation are great: for example, Pickard & Co., a small firm with 3,500 accounts suspended by the Exchange in 1968, required 30 Exchange examiners working more than 18 months with the help of firm employees and auditors to resolve errors in records.
>
> * * * *Announcement of suspension of these major firms could have prompted a run by customers on firms which did not have a problem.* With investor confidence shaken, the effect even on healthy firms might have been major. The chain effect of these events could have been grave.

At about the same time as the second net capital inspection of the NYSE in 1970 the Commission and the Exchange entered into two series of correspondence which demonstrated their differences of opinion regarding the net capital rule. First, they disagreed as to what action the NYSE should take against a member who violated the rule. Second, negotiations began over the NYSE's proposed amendments to rule 325 which eventually culminated in the full scale revision of July 1971.

Suspension of Member Organizations.—The first series of correspondence was commenced by Chairman Budge upon learning of the dire straits of Goodbody & Co. when he wrote to the Exchange asking what steps it was taking to protect Goodbody's customers. He added:

> As you are aware, it is the Commission's position and it has so advised the Congress in connection with "SIPC" legislation that if any firm was permitted by the Exchange to operate while in net capital deficiency, the Exchange would have to accept responsibility for the losses suffered by customers of such firm.[85]

Mr. Haack's reply reminded the Commission that "Exchange Rule 325 specifically provides that in the case of a particular firm the Exchange may make a specific temporary exception to the capital rules 'due to unusual circumstances.' "[86] He went on to point out that:

> The Exchange Constitution and Rules do not authorize immediate suspension of a member firm simply because of a net capital deficiency. The provisions of Article XIII which require suspension of a firm for insolvency necessitate a finding that the member firm has "failed to meet its engagements" or is "insolvent" or "is in such financial or operating condition that it cannot be permitted to continue in business with safety to its creditors or the Exchange." The Exchange had no basis for reaching any of these determinations on the date it first learned from the auditors of the net capital deficiency which existed in Goodbody & Co.[87]

On November 10, 1970 Chairman Budge wrote again, stating the position taken in Mr. Haack's letter "is inconsistent with the Exchange's representations previously made to the Congress and

[85] Letter from Hon. Hamer H. Budge to Robert W. Haack (October 16, 1970).
[86] Letter from Robert W. Haack to Hon. Hamer H. Budge, p. 5 (October 23, 1970).
[87] *Id.* at 2.

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the Commission * * *"[88] and suggesting that the Commission was considering withdrawal of the NYSE's exemption from Commission rule 15c3–1:

> Under Sections 8(b) and 15(c) of the Securities Exchange Act of 1934, and Rule 15c3–1 thereunder, it is illegal for a broker-dealer to continue to do business when his net capital ratio exceeds 2000%. Both Congress and the Commission have thus determined that a firm in net capital violation is inherently in such serious financial condition as to warrant its being prevented from continuing in business. In any event, in light of the position expressed in your letter, an additional serious question is raised as to the validity of the basis for the exemption from the Commision's net capital rule accorded to members of the New York Stock Exchange.[89]

However, Mr. Haack reiterated the NYSE's position that its constitution and rules did not permit summary suspension of a member organization without first making a finding of insolvency or of danger to creditors or the Exchange. He then pointed out the practical problem faced by the Exchange in vigorously enforcing its net capital rule on the one hand and in affording minimum requirements of due process of law to its members on the other:

> The Exchange is the defendant in two law suits * * * arising out of the suspension of that former member firm in November 1963. The substance of those complaints is that the Exchange acted prematurely and without sufficient facts in suspending the firm under Article XIII of the Constitution because of its financial condition. A total of $12 million in damages is sought from the Exchange in these two actions.
>
> * * * * * * *
>
> It does not seem to us that if the Commission decides to revoke the Exchange's exemption from the Commission's net capital rule, as the letter hints might be done, that this action, in and of itself would be sufficient to alter the situation with respect to the Exchange Constitutional guarantees for due process.[90]

The Commission responded on November 25, 1970 with a comprehensive rebuttal of Mr. Haack's letter. It stated in part:

> In at least two respects, your letter dated November 20, 1970 on behalf of the Exchange appears to reflect a lack of appreciation of fundamental aspects of the federal securities laws. The first relates to the essence of broker-dealer net capital requirements and the proper response on the part of those who administer them when they discover non-compliance.
>
> * * * * * * *
>
> The vital principle to be distilled from the unequivocal provisions of Section 15(c)(3) is that a broker dealer who is not in compliance with Rule 15c3–1 is by that circumstance

[88] Letter from Hon. Hamer H. Budge to Robert W. Haack, p. 1 (November 10, 1970).
[89] *Id.* at 2.
[90] Letter from Robert W. Haack to Hon. Hamer H. Budge (November 20, 1970).

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alone prohibited from engaging in any over-the-counter business.

* * * * * * *

By the same token, the provision in paragraph (b)(2) of the Rule exempting members in good standing of specified exchanges (including the New York Stock Exchange), upon the assumption that their "rules, settled practices, and applicable regulatory procedures" are more comprehensive than those of Rule 15c3–1 is necessarily founded on the premise that the non-compliance by a member organization of such an exchange should, at a minimum, result in the same consequences to such a member as regards discontinuing all over-the-counter business as apply to nonmember brokers or dealers who violate the Commission's rule.

* * * * * * *

Accordingly, it is clear that non-compliance by a member organization of the New York Stock Exchange with its net capital requirements establishes alone that the organization is in such financial condition that its continuing to carry on business endangers the safety of its customers and other creditors.

* * * * * * *

We believe that the Exchange must recognize these fundamental principles if it is to fulfill its statutory obligations.[91]

The NYSE replied on December 10, 1970 in part:

> The record clearly indicates over all of the years during which the Exchange has reported disciplinary actions to the SEC that the Exchange has never considered that any violation of its net capital Rule 325 necessarily resulted in suspension from the Exchange. . . .
>
> In addition, I do not understand your suggestion that the exemption for Exchange members contained in SEC Rule 15c3–1 "is necessarily founded on the premise that the non-compliance by a member organization of such an exchange should, at a minimum, result in the same consequences to such a member as regards discontinuing all over-the-counter business as apply to nonmember brokers or dealers who violate the Commission's rule." . . .
>
> You can be sure the Exchange recognizes its responsibilities under all sections of the 1934 Act. Over the years, it has, we believe, discharged those responsibilities ably.[92]

The Commission's files reveal no further correspondence on this matter and no Commission action to compel the NYSE to conform its conduct to the Commission's strongly stated views. Nor did the Commission carry out its suggestion that it might terminate the exemption from rule 15c3–1 for members in good standing of the NYSE.

"Phase I" Amendments.—The second series of correspondence between the Commission and the Exchange also demonstrated fundamental differences in their respective interpretations of the purpose of net capital rules. However, in the end, the Commission was more

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successful in urging its position upon the NYSE than in other areas of disagreement. On October 1, 1970 the NYSE forwarded a broad scale revision ("Phase I") of rule 325 to its members for comment. After considering the proposed revisions, the Commission authorized the Division of Trading and Markets to respond in part as follows:

> As you are aware, the exemption which your members were granted three decades ago from the net capital test administered by the Commission was based on the premise that the Exchange's net capital test was the more stringent one. Over the course of the years, changes in the interpretation of our respective rules, and differences in enforcement practices, have resulted in a reversal of the stringency of the two rules to the point where the question must be raised whether the exemption previously accorded is still justified. We regret to report that our analysis of the proposed changes to the Exchange's net capital rule does not indicate a sufficient strengthening to obviate that question.
>
> Indeed, in some areas, it appears that the revisions would merely codify existing weak interpretations, while in other areas, they would further relax the standards now in effect. The regressive character of the proposals is not due to specific language which could be altered easily, but rather is due to their fundamental premise that the net capital test should be geared to a firm's "operating cycle" or "credit worthiness". On the basis of recent experience, however, we can see no justification for departing from the liquidity concept which previously underlay both the Commission's and the Exchange's net capital rules.[93]

The files reveal no further correspondence between the Commission and the Exchange regarding the October 1 draft. However, on January 21, 1971 the Exchange did submit, pursuant to Commission rule 17a-8 a slightly revised draft which had, by this time, been approved in principle by the Board of Governors.[94] The Commission authorized the Division to comment upon the proposed amendment on February 10. The Division's letter referred the Exchange to its previous comments of October 9 and, after discussing the proposal in detail, concluded:

> We regret that our analysis of the proposed amendments to Rule 325 indicates that whatever little progress there might be in some areas would be counter-balanced by regress in other areas. Overall, there would be no appreciable strengthening of an already inadequate standard of financial responsibility.[95]

Among the matters left unresolved after the Commission's letter of February 10, 1971 were different views regarding treatment of short stock record differences, dividends and interest receivable and security haircuts.[96] On April 6, 1971 Commissioner Needham, after discussions with the NYSE, reported to the Commission that the Exchange was ready to concede on certain points and that compromise

[93] Letter from Irving M. Pollack to Robert W. Haack (October 9, 1970).
[94] Letter from Robert M. Bishop to Irving M. Pollack (Jan. 21, 1971).
[95] Letter from Irving M. Pollack to Robert M. Bishop (Feb. 10, 1971) p. 9.
[96] *Id.* at 4.

For example, fairly frequently an examiner, as a result of a visit or questionnaire analysis, will report a possible capital violation, which after investigation will prove not to be a violation because of reporting errors causing incomplete understanding between the Exchange, the member firm and sometimes its auditors.

[47] Letter from Robert W. Haack to Irving M. Pollack (July 15, 1968).
[48] Letter from Irving M. Pollack to Robert W. Haack (July 18, 1968).

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positions had been suggested on the manner of treating short stock record difference and receivables. On May 24, 1971 representatives of the Exchange met with members of the Commission and its staff to explain the Exchange's pending net capital proposals.[97] As a result of the May 24 meeting the Exchange, on May 28, 1971, submitted its final proposed net capital amendments under Commission rule 17a–8.[98] The May 28 proposals embodied the compromise provisions to which Commissioner Needham had referred on April 6.

The Commission's comments on the Exchange's May 28 proposals were contained in a letter of June 17, 1971. In the letter the Director of the Division of Trading and Markets reiterated some of the Commission's earlier comments and discussed the Exchange's amended proposal at length. He summarized the Commission's views as follows:

> We regard the new Exchange net capital package (Phases I & II) as a step forward in the strengthening and clarification of your current provisions. However, where certain specific Exchange proposals would result in a weakening of its current posture, a significant variation from more rigorous Commission practice or a departure from our recommendations made in this letter you should make all efforts to adopt the approaches in this letter as soon as possible.[99]

When the NYSE Board of Governors did adopt the new net capital package on July 15, 1971 it incorporated several additional amendments in response to Mr. Pollack's letter of June 17. Thus, though it had not persuaded the NYSE to adopt its view on all of the areas of difference, the Commission had, through a process of negotiation, made a significant contribution to the drafting and strengthening of the Exchange's net capital rule.

Securities Investor Protection Act of 1970. In response to the financial crisis in the securities industry Congress enacted the Securities Investor Protection Act of 1970.[100] The SIPC Act, which became effective on December 30, 1970 provides insurance to cover customer claims against insolvent broker-dealers of up to $50,000 in the case of securities and up to $20,000 in the case of cash.

Almost simultaneously with enactment of SIPC the financial crisis in the industry began to ease. During calendar year 1971, for example, the 330 NYSE member organizations carrying public customer accounts in the aggregate recorded a profit on security commission business whereas in 1970 a net loss had been recorded.[101] The easing of the financial squeeze and the existence of SIPC made it possible for the Exchange, in 1971, to begin to phase out its customer assistance program.[102] However, the Exchange's return to normalcy is complicated by the pendency of some 30 lawsuits seeking untold millions of dollars

[97] Letter from Robert M. Bishop to Irving M. Pollack (May 28, 1971). In addition to the proposals submitted on Jan. 21, 1971 the meeting concerned proposals submitted on Feb. 19, 1971 ("Phase II"). These amendments lowered the maximum net capital ratio permitted for member organizations to 15 : 1, increased that minimum net capital required from $50,000 to $100,000 and contained provisions designed to improve the *quality* of member capital by limiting withdrawal and requiring that it be contributed for a longer period of time.

[98] Letter from Robert M. Bishop to Irving M. Pollack (May 28, 1971).

[99] Letter from Irving M. Pollack to Robert M. Bishop (June 17, 1971) p. 12.

[100] Pub. L. No. 91–598.

[101] New York Stock Exchange, Inc., Security Commission Business, Calendar Year 1971, p. 2 (1972).

[102] New York Stock Exchange, Inc., Annual Report 1971, p. 18.

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in damages based at least in part upon claims either that the Exchange failed to enforce its applicable capital rules against a member organization or that the Exchange had a duty to advise interested persons that a member organization was in violation of the Exchange's applicable capital rules.[103]

As stated, the NYSE adopted a new, stronger net capital rule in 1971. In 1972 the Commission adopted amendments to strengthen rule 15c3–1 and took other measures designed to avoid future financial crises.[104] And, in December of 1971 the National Association of Securities Dealers for the first time announced that it was considering adoption of a net capital rule.[105] On December 5, 1972 the Commission formally proposed a uniform net capital rule which, if adopted, will apply to all brokers and dealers, regardless of membership on a national securities exchange.[106]

On December 28, 1971 the Commission transmitted to Congress its Study of Unsafe and Unsound Practices of Brokers and Dealers containing its analysis of the financial and operational crisis of the late 1960's and its recommendations for legislation to avoid a recurrence. The findings and recommendations relevant to this case study were the following:

> 2. . . . The Commission believes that the public interest would be better served if it had plenary authority with respect to the rules of the self-regulatory bodies. . . . The specific authority sought would be that to approve or disapprove of any new rule proposal or any proposed amendment, supplement or repeal of an existing rule, as well as the authority to require rule amendments and supplements, and the authority to abrogate rules. Action pursuant to such authority should be preceded by appropriate notice and afford an opportunity for hearing.
>
> 3. . . . A limitation of the Commission's oversight power over the self-regulatory bodies is that it cannot directly enforce their rules against their members.
>
> 4. . . . it would be appropriate for the Commission to have the right to review all disciplinary proceedings of a self-regulatory body upon appeal or on the Commission's own motion, and that such right to review include the power to affirm, disaffirm or modify in any way deemed to be required in the public interest, the findings of and penalties imposed by the self-regulatory body.[107]

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[103] Exhibit D. Although these actions are in various stages, it should be mentioned that the Exchange has successfully interposed matters of defense in several of them. For example, in an action in which the plaintiff alleged that the Exchange was guilty of "gross negligence, gross carelessness, gross recklessness and abysmal ignorance and utter stupidity" the trial court granted the Exchange's motion to dismiss and an appeal is pending. *Id.* And see T. Robards, *Lawsuit Is Filed; Names Big Board*, The New York Times, August 7, 1970, at 39, col. 2.

The Exchange's dilemma in enforcing rule 325 is illustrated by the fact that it is also the defendant in actions seeking $12,000,000 damages based at least in part upon allegations that it acted prematurely and without sufficient facts in suspending a member organization because of its financial condition. See text *supra* at p. 354.

[104] See, *e.g.* SEC Securities Exchange Act Releases Nos. 9482, 9496, 9587, 9594, 9633, 9654, and 9691 (1972).

[105] See N. Wolfson & E. Guttman, *The Net Capital Rules for Brokers & Dealers*, 24 Stan. L. Rev. 603, 640 (1972).

[106] Exhibit E.

[107] Unsafe & Unsound Practices Report at 6. The Commission's specific legislative proposals are contained in H.R. 15303, 92d Cong. 2d Sess.

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III. SELECTED REGULATORY PROBLEMS

A. Informality of Procedure

As has been pointed out,[108] the Commission staff felt that during the financial crisis the NYSE at times interpreted its net capital rule flexibly in order to avoid finding member organizations to be in violation. The Exchange disputes this finding. However, the Exchange did seem to feel that some flexibility was a necessary incident of administration of the net capital rule. For example, in connection with its 1964 net capital inspection of the Exchange, the Commission's staff questioned the NYSE Chief Examiner in not establishing an inspection manual or procedures for use by examiners in inspecting member organizations. When the matter was brought to the attention of the Exchange, however, a Commission memorandum reports that an officer of the Exchange explained that all of the examiners were trained brokerage accountants and that a manual might inhibit their "feel" for questionable situations. He reportedly stated that the absence of a manual was primarily a matter of respecting professional competence. Nevertheless, the suggested manual was instituted in 1965.

In December of 1969, an Exchange officer, in declining to provide the Commission with statements of reasons for placing individual member organizations on restrictions, advised the staff of the Commission that the Exchange wished to give its coordinators "maximum informality and flexibility in the depth of inquiry they make of the firms assigned to them."

In 1971, after making a detailed examination of the Exchange's early warning system, the Commission's staff again criticized the Exchange's lack of objective standards in interpreting its net capital rule. The program, according to the Commission's staff, lacked parameters, definitions and guidelines as to the specific nature and scope of the inquiry to be conducted in responding to the questions.

One consequence of the flexibility regarding capital compliance of particular member organizations was that it was difficult at times for the Commission and its staff to determine whether a given firm was in or out of compliance. In April of 1970 the staff reported to the Commission "We have found it difficult to gauge the extent of firms' financial problems because of the conflicting net capital computations made by the firms themselves and by the self-regulatory organizations." And, in connection with First Devonshire Corporation the Commission's staff reported in June of 1970 "The firm has apparently been in net capital violation since March. It is unclear, because of computational differences between the firm and the Exchange just what the firm's ratio is, but the firm computed it as 2,596 percent as of March 26."[109]

Another possible consequence of the flexibility with which the Exchange interpreted its net capital rule is that the Exchange itself may have occasionally lost track of the standards pursuant to which the rule was being interpreted. After the 1964 and 1970 net capital inspections the Commission's staff advised the Exchange that its examiners

[108] See text *supra* at pp. 347–351.

[109] The Exchange maintains that a 2596 percent ratio was computed *by the Exchange* based upon its analysis of the firm's answers to a special financial questionnaire. The *firm's* computation of its ratio as of this date was, according to the Exchange, 1778 percent.

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had apparently engaged in a policy of liberal interpretation of the rule. In both instances the Exchange staff expressed surprise at this finding.[110] Although the Commission's files established no causal relationship, the Exchange's uncertainty could conceivably have been attributable in part to the lack of formalized standards of interpretation of the rule for use by its examiners and other employees.

A third consequence of flexibly interpreting rule 325 appeared to be some diffusion of the lines of responsibility for financial reporting by member organizations. In a conference held in January of 1970 NYSE officers advised the Commission that the Exchange would not require the annual financial statements mailed by a member organization to its customers to disclose that the firm was in net capital violation at the time of its audit. They indicated that this was a matter left up to the accountants. If the accountants did not believe that the fact of violation was material, the Exchange's staff would not insist upon disclosure.

Accountants, on the other hand, on at least one occasion indicated that they looked to the Exchange in interpreting rule 325 on a case-by-case basis. On September 28, 1970, a representative of one of the major accounting firms, when asked by the Special Committee of the New York Stock Exchange about the treatment of short stock record differences in computing net capital replied: "Frankly, I am not sure. What we would do is probably call the Exchange and ask for the suggested treatment. You know, we have been up this path on differences a couple of times."[111]

A fourth problem caused by flexible interpretations of NYSE Rule 325 related to the application of Commission Rule 17a-8. Prior to 1964 the Commission relied upon a letter agreement with the NYSE pursuant to which the Exchange agreed to give the Commission two weeks advance notice of material changes in its rules except in unusual circumstances.[112]

In March of 1964, however, the Commission promulgated rule 17a-8 which provides in relevant part:

> (a) Each national securities exchange shall file with the Commission three copies of a report of any proposed amendment or repeal of, or any addition to, its rules not less than three weeks (or such shorter period as the Commission may authorize) before any action is taken on such amendment repeal or addition by the members of such exchange or by any governing body thereof....[113]

Prior to adoption of rule 17a-8 the Commission's staff had under specific consideration the question of what kind of material constitutes an exchange "rule." However, the rule, as adopted, defines the term "rules of an exchange" in only the most general terms:

> (c) For the purpose of this rule the term "rules" of an exchange shall mean its constitution, articles of incorporation, by-laws, or rules or instruments of incorporation, bylaws, or rules or instruments corresponding thereto whatever the name, and its stated policies.[114]

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[110] See text *supra* at pp. 838, 851.
[111] NYSE, Transcript of a Meeting of the Special Committee of the Board of Governors held Sept. 28, 1970, p. 6.
[112] See, e.g. 4. Special Study 725.
[113] 17 C.F.R. sec. 240. 17a-8.
[114] 17 C.F.R. sec. 240.17a-8.

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As stated previously,[115] the interpretations used by the Exchange in finding its members in compliance with Rule 325 were not treated as "rule" changes and therefore were not submitted to the Commission under rule 17a–8. In at least one instance the Commission did not even learn of the change in "interpretation" until seven months after implementation at which time it conducted a net capital inspection of the Exchange.[116]

At hearings of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce the following discussion took place between Chairman Moss and Soloman Litt, a member of the Exchange's Board of Governors and Chairman of its Capital Committee concerning the difference between a "rule" change which would have to be submitted in advance to the Commission under rule 17a–8 and a "substantive change" which, while it would have the same effect as a rule change, apparently would *not* have to be submitted pursuant to rule 17a–8:

> Mr. LITT. Mr. Chairman, this was not a rule change.
>
> Mr. Moss. I recognize it was not a rule change. It was a substantive change.
>
> Mr. LITT. Many accounting firms adhere to the old rule of charging off——
>
> Mr. Moss. Won't you agree that, being a substantive change, it had the effect of a rule change?
>
> Mr. LITT. I am sorry, I would not agree because I think a good deal of it was an interpretation of the accounting firms who did the audit of these firms.
>
> Mr. Moss. The allegation is made, Mr. Litt, that the New York Stock Exchange changed its policies at that point. Now, let us take that as the basic premise. If that is correct, would you agree that it had the effect of a rule change?
>
> Mr. LITT. I don't want to be quibbling with you, Mr. Chairman, but I don't think they even changed their policy. I think they went along with a more liberal interpretation that was being put by accounting firms on the conditions of certain member firms which they examined and realizing that the back office problems were so horrendous in some of these firms, they went along with this interpretation. There was no rule made.
>
> Mr. Moss. Would you disagree, sir, with the characterization of it as a substantive matter by Mr. Pollack?
>
> Mr. LITT. Yes, it was substantive.
>
> Mr. Moss. It was substantive?
>
> Mr. LITT. In those firms where this was a consideration, it was substantive.
>
> Mr. Moss. But it had to have concurrence of the exchange in order for them to accept the report and not find firms in violation because of this large accumulation of short stock record differences. To that effect it did represent change in policy on the part of the exchange. You said that it was a substantive change. It was a substantive matter. Therefore the change would have to be substantive.

[115] See text *supra* at p. 348.

[116] Id. As indicated earlier, however, the Exchange maintains that there was no such policy change and that the Commission was fully aware of the Exchange's treatment of bookkeeping differences (the subject matter of the reported change) as far back as 1966.

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> Mr. LITT. That is also true. It was the question of the exchange accepting a certain interpretation and treatment of this particular problem on the part of certain member firms, the alternative being that probably the strict application of the rule might at any particular moment have put them out of business.
>
> Mr. Moss. A substantive change in application of the rule then results in amendments of or modification of the rule, does it not?
>
> Mr. LITT. Well, you have got me on that one, sir. I am not a lawyer and I won't want to argue on that.
>
> Mr. Moss. I think we are on equal grounds. Neither am I.
>
> Mr. LITT. Thank you very much for the compliment.[117]

Although the Commission amended its net capital rule effective September 29, 1972 to further limit the exemption for members of exchanges whose rules provide for "ratios and net capital at least equal to the minimum ratios and net capital required" by the Commission's rule, the amended provision does not deal with the question of *interpretations* of Exchange rules which do not themselves rise to the dignity of "rules." [118] Nor has rule 17a–8 been amended to clarify the definition of the term "rules of an exchange."

B. Commission Access to Exchange Files

Section 17(a) of the Securities Exchange Act [119] empowers the Commission to promulgate rules and regulations regarding the books and records to be maintained by national securities exchanges and their members and concludes:

> *Such* accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examinations by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors. (Emphasis added.)

Although the Commission has adopted several rules under section 17(a) regarding records to be maintained by *members* of national securities exchanges, it has not adopted a general record-keeping rule applicable directly to the exchanges themselves.[120]

Section 17(a) does not by its terms confer statutory authority upon the Commission to examine Exchange files *absent* such a rule although the Commission has always taken the position that section 17 does by implication grant general inspection powers over all exchange records.[121] The Commission, however, has frequently relied upon voluntary cooperation in keeping itself advised regarding the Exchange and its members.

Failing cooperation, the Commission has resorted to its general investigatory powers under section 21(a) of the Act.[122] Section 21(a),

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[117] 2 House Hearings at 564–565. The Exchange's description of its treatment of short security differences in computing capital ratios appears in Exhibit C.

[118] See text *supra* p. 4, fn. 11.

[119] 15 U.S.C. § 78q.

[120] The Commission's files do reveal that at one time a "proposed Exchange record keeping rule" was apparently under consideration. Letter from Irving M. Pollack to Lee D. Arning, p. 2 (January 15, 1969). However, no such rule has been formally proposed or adopted.

[121] See, e.g., E. Weiss, Registration & Regulation of Brokers & Dealers 46 (1965).

[122] 15 U.S.C. § 78a.

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however, contemplates that the Commission's powers be exercised only after commencement of a formal investigative proceeding and it is important that the Commission be able to obtain access to exchange files in its day-to-day surveillance of the self-regulatory process without resort to the procedures required by section 21(a).

As has been pointed out,[123] during the financial crisis of the late 1960's the Commission and the NYSE did not always agree on the extent to which the Commission and its staff should have access to information contained in Exchange files. However, the degree to which the Commission was hindered in obtaining complete access to Exchange files during the financial and operational crisis has not been fully explored. The following testimony was received in hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce on August 3, 1971:

> Mr. Moss. I have a question that I want to ask the New York Stock Exchange.
>
> On the staff study, [Demise] pages 37 and 82, the staff raises the question of the SEC's access to files which the staff felt pertinent pertaining to the New York Stock Exchange member firms.
>
> There is an indication, though, that these files had been refused to the Commission.
>
> What was the nature of the information there which was not available to the Commission?
>
> Mr. ARNING. Well, Mr. Chairman, I am at a loss to account for the language and the representation that is made in this document. I am not aware of any change. What might possibly account for this—and it is a guess, and maybe Mr. Pollack can amplify this—I think the Commission undertook one of its regular oversight visits in October of 1970 at which time they took away copies, as is their usual practice, of a substantial number of documents; and when this visit was made by the staff committee, they must have found a great deal of documents dating from that time.
>
> Mr. Pollack may be able to comment much more validly than I; but so far as I know, in the time we have been at the exchange, we have endeavored to cooperate with the regional office, the Washington office, and the main office of the Commission, to whatever extent possible, and we have provided data by the truckload.
>
> Mr. Moss. Mr. Pollack, would you care to comment on that?
>
> Mr. POLLACK. I cannot comment on the specific cases, but I would say that there was some data during this period that the exchange was reluctant to make availble to us. I think we may refer to that in the Staggers' letter (exhibit B), that they had collected; and I think that the basis on which they were reluctant to do so was that the information might be used in administrative or other actions against their members, and for that reason they were reluctant in turning it over to us. In any event, we, of course, could have obtained it by subpena if we had the desire to do so; and as is indicated in here, during most of this period we were able to get any information that we needed by going to the exchange and inspecting their files.

[123] See text *supra* at 21–23. See also Demise at 37, 82.

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So, I think that this may refer to some of the individual firm data or some of the general data that the exchange had the desire to do so; and as is indicated in here, during most of this period we were able to get any information that we needed by going to the exchange and inspecting their files.

Mr. BISHOP. If I might just refine that a little bit, we prefer that the SEC obtain it by proper legal process in order to give us a legal protection which our counsel was advising us that we should have.

Now the SEC has available two methods of doing this: One is by having someone come in and get it, and the other one is by sending us a subpena for it. And it was just a difference of whether we mailed it down to them or they came in and got it.

So I think, from a practical standpoint, the SEC got everything that it really wanted throughout the period.

Mr. MOSS. Well then, the fact is that the SEC does have the necessary power to gather this information whenever it feels it is necessary to have it or desirable to have it?

Mr. POLLACK. Yes, sir; I think we have the power to require them to produce the information. I think the difficulty is, as Mr. Bishop has indicated, whether, when we inspect to ask for documents, it is necessary for us to obtain a subpena to obtain them rather than to do it under the general inspection power under the statute.

Mr. BISHOP. We have never deemed that when a SEC person came in and took the documents they had to have a subpena, only when they were just asking us to send them. I believe that is the position our counsel has taken.

Mr. RAPPAPORT. I think if I may add something to that, Mr. Chairman——

Mr. MOSS. Mr. Rappaport.

Mr. RAPPAPORT. As I understand the position of the counsel for the New York Stock Exchange, because we have come across this problem in some other areas, this issue in other areas, the stock exchange, I understand, has been advised by its counsel that it may make these documents available to inspectors from the SEC for inspection purposes but that they ought not to make copies of these documents or give the documents in the stock exchange files to the inspectors from the Commission without that subpena from the Commission.

And it is conceivable that the stock exchange officials were willing to permit our people—might have been willing to permit them—to look at the documents, but not to make copies or have copies made for our people to take back, say, to the headquarters office here in Washington for the Commission to see.

I might add, to my knowledge, we have not had any question along those lines from any of the other self-regulatory organizations.[124]

[124] 1 House Hearings 147–149. See also 2 House Hearings 974, 991–992 in which it is explained that notification of the Commission by the NYSE that a member organization was in violation of the net capital rule depended upon whether and when disciplinary proceedings were initiated by the Exchange.

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Perhaps because it had not conducted a net capital inspection of the NYSE since 1964, the Commission possessed only limited information about the Exchange community at the beginning of the financial and operational crisis. For example, an NYSE circular to member organizations of March 14, 1968 caused the Commission's staff, among itself, to raise questions concerning: requests by members for extensions of time in which to complete financial questionnaires; the nature and extent of member organization operational problems; the nature of the NYSE's "special reporting" program for firms with operational problems; the nature and extent of restrictions imposed on members' business; and the extent of record keeping problems being experienced by member organizations. It does not appear from the Commission's files that these questions had been raised prior to the NYSE circular of March 14, 1968 or that the Commission was aware of the problems referred to in the circular. In 1969 the Commission asked questions such as the following of the Exchange:

> Do you regularly receive current reports which indicate whether any member firms are having financial difficulties? What special steps is your organization taking or considering to obtain information which would enable you to anticipate financial difficulties? Do you receive monthly trial balance information from member firms? Do you have a program of prophylactic steps which the member and your organization can take to prevent anticipated financial problems? [125]

In an apparent attempt to become more familiar with matters relating to the financial responsibility of member organizations the Commission, beginning in about 1968, made numerous requests for information from the NYSE. In many instances the Exchange complied with these requests either though oral briefings or written summaries. The Exchange regularly furnished the Commission with reports of disciplinary proceedings against individual member organizations involving capital rules and with a list of firms subject to NYSE imposed restrictions. These were supplemented from time to time by letters dealing with particular situations or responding to Commission inquiry. However, differences did arise.

In December of 1969 a Commission attorney asked the Exchange that, in addition to a *list* of firms filing special operations questionnaires, the Exchange supply a brief statement of the *reasons* for adding a firm to or deleting it from the list. The Exchange's response demonstrated considerable sensitivity as to the relationship between the Commission and the Exchange:

> I wish to give our Coordinators maximum informality and flexibility in the depth of inquiry they make of the firms assigned to them. Consequently, I do not ask them to justify adding or subtracting a firm from our monthly operations questionnaire list. If this list becomes another indication to the SEC of the operations condition of member organizations, we would need to carefully supervise and control the composition of this list, and the effectiveness of our admin-

[125] Letter from Hon. Hamer H. Budge to Robert W. Haack (September 12, 1969).

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istrative surveillance will be adversely affected. This was the reason I was reluctant to agree to send you the monthly lists.

Your December 4th request for a reason for each firm being on the list and for future changes indicates why our people would need to be very circumspect about adding firms to the list. In the interests of maintaining the integrity of our surveillance, therefore, I must decline to send you such future reports.

Further difficulties were encountered when the Commission's staff conducted a net capital inspection of the NYSE in January and February of 1970. The staff reported to the Commission that, when it asked to see the agenda and minutes of the Board of Governors, Exchange officers and staff replied that although the minutes were "confidential . . . the Exchange would be willing to prepare for staff a statement of the contents of the documents, but for 'policy reasons' the Board minutes could not be viewed."

In connection with its request to review the minutes of the Advisory Committee the staff reported to the Commission:

> It should be pointed out that it took two days to locate these minutes. Members of the Exchange staff and counsel . . . all indicated that minutes of the Advisory Committee did not exist. It was not until a member of the inspection crew questioned some of the lower staff members . . . that a file entitled "Minutes of the Advisory Committee" was found.

In order to obtain access to the documents it desired, on March 4, 1970 the Commission issued an order directing a private investigation of the NYSE under section 21(a) of the Act and reciting that:

> C. During the course of the inspection the staff was unable, after timely requests, to obtain the following documents and records:
>
> (1) Agenda of the Board of Governors where the net capital and industry financial conditions were discussed;
>
> (2) The minutes of such discussions;
>
> (3) Memoranda and other documents reviewed and considered by the Board and documents and memoranda resulting from such consideration including, among other things, interpretations of the net capital rule and disciplinary actions.[126]

The Commission's difficulties in obtaining information from the NYSE also extended to information relating to individual firms. For example, on June 4, 1970 the Division of Trading and Markets advised the Commission that it had learned of three more net capital violations by member firms, none of which had been brought to the Commission's attention by the Exchange. In fact, the staff reported, when a representative of Charles Plohn & Co. had inquired of the Exchange whether to notify the Commission of a net capital problem he was "told that it should *not* do so because this was a matter within the jurisdiction of the NYSE." (Emphasis added.) It is interesting to compare

[126] This investigation, which delegates to a member of the staff the power to issue subpoenas, has never been terminated by the Commission.

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the staff's recitals with the testimony of an Exchange officer before the Senate Subcommittee on Securities on April 17, 1970:

> Sen. BENNETT. Do you automatically inform the SEC when a member broker-dealer is not in compliance with the capital rule?
>
> Mr. CUNNINGHAM. We do.[127]

The Commission's staff conducted another net capital inspection of the NYSE in October of 1970[128] As in the January inspection, problems again arose over access to documents. Apparently the Commission's staff took a large number of documents from the Exchange files to Washington for inspection. The Exchange was concerned that the staff had taken draft memos, working papers and other incomplete and fragmentary documents which might require explanation or qualification. An officer of the Exchange wrote:

> Consequently, I urge and request that whenever your staff in this study reviews information which appears to be adverse to the Exchange's performance of its duties, that this information should be checked with us in order to be sure that you have not received an errroneous impression from fragmentary information. Such a request should be clear in its intent and we should be given enough time so that all concerned on our staff may be consulted in order to give you a complete answer.[129]

In his reply, the Director of the Commission's Division of Trading and Markets outlined the procedure by which the Commission obtained copies of NYSE documents:

> Under the procedure which the Exchange has established, copies of all documents which we have requested are first furnished to you for a determination as to whether they will be furnished voluntarily or whether we must subpoena them. Therefore, it would seem that your staff is in a position to evaluate the documents and determine if they contain any misleading information or if they omit any material information. If your own review leads you to conclude that we may have "received an erroneous impression from fragmentary information," we would welcome your submitting additional documents and your briefing us in person as to the extent you deem appropriate. I would suggest that this be done as promptly as possible.[130]

But, the Exchange felt that the procedures followed by the Commission staff had not afforded it sufficient protection:

> The documents which your staff marked for copying and taking to Washington during your current review of our administration of the net capital rule far exceeds in volume any documentation requested in previous reviews. Further,

[127] Federal Broker-Dealer Insurance Corporation, Hearings before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 2nd Sess., p. 197 (April 17, 1970).
[128] See text *supra* at p. 352.
[129] Letter from Robert M. Bishop to Irving Pollack (October 29, 1970).
[130] Letter from Irving M. Pollack to Robert B. Bishop (November 6, 1970).

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your staff was in a great pressure to have these documents transmitted to Washington rapidly.

Consequently, although we made a cursory review of the documents copied, we were not able to make a determination as to those on which we might need the protection of a subpoena. Nor were we able to make any evaluation of whether the documents contained misleading information or omit any material information. Indeed, the volume of documents your staff has taken, and the time span which they cover make it virtually impossible for us to perform such an evaluation.

It seems to me that the only feasible approach is that of management by exception—in other words, your bringing to our attention instances which appear inconsistent with our responsibilities so that we will have an opportunity to be sure that in these matters you have full information.[131]

The Commission's files do not reveal how the dispute over access to documents was resolved. Apparently, however, a meeting was held between the staffs of the Commission and the Exchange to discuss the issues raised by Mr. Bishop's letter of November 11.

In fairness it should be emphasized that the instances of disagreement catalogued above were the exception rather than the rule. At the beginning of this subsection the extensive information furnished by the NYSE to the Commission was described.[132] This information was furnished voluntarily and without the Commission having promulgated a rule under section 17(a) of the Act.

The information contained in the Commission's files indicates that the two agencies have recently begun to work more closely together. On June 12, 1970, for example, a staff attorney reported to the Commission that he and two other Commission attorneys had just had "a very thorough briefing" from the Exchange on the status of financially troubled member organizations.

When the Commission's staff conducted its most recent net capital inspection of the NYSE in 1972 there was no evidence of the former problems relating to access to documents. The staff's report is perhaps the best evidence available of the present attitude of the Exchange and its staff:

> We were quite surprised when the Secretary of the NYSE made available Books 15, 16, 17 and 18 of the Board of Governors' minutes. These books, a private office by ourselves, and as much time as we needed were given to us.

The Commission has not proposed or adopted a rule under section 17(a) of the Exchange Act clarifying the responsibilities of the exchanges to maintain books and records and make them available for commission inspection.

C. Coordination Among Regulatory and Self-Regulatory Organizations

The Special Study pointed out in 1963 that, in the self-regulatory system which governs the securities markets, overlapping memberships

[131] Letter from Robert M. Bishop to Irving M. Pollack (November 11, 1970).
[132] See text *supra* at p. 865.

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and jurisdictions are the rule rather than the exception.[133] The great majority of Exchange member organizations are also registered as brokers or dealers with the Commission and in one or more states and are also members of the National Association of Securities Dealers, Inc. ("NASD"). For firms with multiple memberships any unnecessary duplication or lack of coordination quickly translates into excessive overhead. Regulatory and self-regulatory agencies, with large tasks and limited budgets, must avoid duplication and achieve coordination if they are to fulfill their statutory responsibilities.[134] The Special Study concluded that—

> . . . available mechanisms, budgets, and personnel of some agencies already seem overtaxed, and at the same time there appears to be considerable duplication of effort among the various agencies in certain respects, adding to the burdens on the agencies themselves and on broker-dealers subject to multiple regulation. In the interests of the public, the regulatory agencies and the securities industry, further and continuing attention should be given to possibilities for coordinating efforts and allocating responsibilities in a more efficient and productive pattern, without limitation on any self-regulatory agency's freedom to have special measures or programs for its own membership. Among such possibilities would be further standardization of application and report forms for firms and individuals, to be used by all interested agencies with appropriate supplementation by each to serve its special needs; further development of centralized examining and investigating procedures, again with appropriate supplementation to meet special needs of each agency; coordination of efforts in defining standards of conduct in areas of common concern; clearer recognition of one agency or another as having primary enforcement responsibility in respect of particular categories of firms or subject matters; and stronger lines of communication among agencies to facilitate channeling of information relevant to the interests of each.[135]

Even though the Special Study reported signs of significant strides toward cooperation and coordination among regulatory agencies,[136] the self-regulatory system is still operating at below maximum efficiency. The Commission and the self-regulatory agencies have over the years arrived at general understandings governing allocation of regulatory responsibilities. But these understandings are informal and tend to be somewhat inexact in practical application.[137]

The administration of stock exchange net capital rules provides a good context in which to consider the benefits of coordination among regulatry and self-regulatory agencies. For, in addition to the obvious savings which would accrue from elimination of duplication in inspections and reporting, the exemption from Commission rule 15c3–1 for

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[133] See 4 Special Study 728–729.
[134] *Id.*
[135] *Id* at 738.
[136] *Id.* at 732–734.
[137] Compare the several descriptions of these understandings at 3 House Hearings 1713–1714 (SEC), 1732 (NYSE) & 1739–1742 (NASD), Securities Investor Protection Corporation, Annual Report for the period ended December 31, 1971, pp. 30–31.

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members in good standing of certain exchanges makes cooperation an essential of effective regulation. A hypothetical case is illustrative. Suppose:

> X is a NYSE member firm, a registered broker-dealer (SEC), a member of the NASD and of the Midwest and Pacific Coast Stock Exchanges.
>
> X is therefore subject to NYSE rule 325 and not to the Commission's net capital rule.[138]
>
> The Midwest and Pacific Coast Stock Exchanges and the NASD rely upon the NYSE to inspect X and enforce the NYSE net capital rule as to X.[139]
>
> The NYSE finds X in violation of its net capital rule and "permits" X to resign as a member.
>
> X is still a member in good standing of the Midwest and Pacific Coast Stock Exchanges and therefore exempt from Commission rule 15c3–1. The Commission cannot proceed against X.
>
> The Midwest and Pacific Coast Stock Exchanges are still relying on the NYSE as the primary regulator of X and will continue to do so until notified of the resignation.
>
> Therefore, unless the NYSE notifies the other exchanges of the resignation of X and of the underlying facts surrounding the resignation, X can continue to do business with the public although it is probably in violation of all applicable net capital rules.

This hypothetical fact situation demonstrates that cooperation among agencies is necessary not only to avoid inefficiency and excessive cost, but, at times, to make the regulatory system work as intended.[140] To be sure the regulatory and self-regulatory agencies have taken and are taking steps to work together. Some of these measures are detailed in the Special Study and the House Hearings.[141] But, the administration of net capital rules during the recent financial crisis does demonstrate some of the difficulties encountered in seeking such coordination.

In the fall of 1969 the Commission adopted a leadership roll in getting the various self-regulatory agencies to work together to solve operational and financial problems. The Commission invited the major exchanges and the NASD to attend a meeting in October to discuss such topics as:

> Existing programs for obtaining information about financial and operational conditions on an overall industry as well as specific broker-dealer basis;
>
> The review and evaluation being made of such information and its utilization to project individual and industry-wide conditions;
>
> The sufficiency of the criteria currently used to evaluate the condition of the industry and the adequacy of the flow and interchange of information among all regulatory groups; and

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[138] See text *supra* at 332.
[139] See, *e.g.* 3 House Hearings 1713.
[140] The Commission has recently promulgated rules to help assure that the notices suggested by the hypothetical case will be given. 17 C.F.R. 240. 17a–5(j), 240–17a–11. Moreover, the Exchange announces in its Weekly Bulletin when any firm ceases to be a member of the NYSE. All regional exchanges receive copies of the Bulletin.
[141] *Supra* notes 134, 135.

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Programs for dealing with situations where serious financial or operational inadequacies are disclosed.[142]

At the October meeting the staff of the Commission presented for industry consideration a proposed form of questionnaire to be used as the basis of a system to gather data on the financial condition of the industry in general as well as of individual firms and groups of firms. However, as the Commission indicated in a letter to Hon. Harley O. Staggers of January 12, 1971, the meeting did not produce agreement.[143] The Commission's staff reported in a memorandum of December 8, 1969:

> The New York Stock Exchange and the American Stock Exchange raised certain objections to the Commission's proposal. Basically each felt their existing programs together with those about to be implemented would accomplish the intended with respect to their member firms.
>
> The New York Stock Exchange felt that the Commission already collects enough data on the operational and financial conditions of broker-dealers. Collection of more data leads only to a continued proliferation of required information to be furnished to the Commission. The Commission continues to require more and more information without terminating any older programs. This burden on brokers was the basis for objection. The NYSE felt that requiring all firms to supply monthly or quarterly data was an undue burden on the firms that have no operational difficulties. This would burden these firms because of problems they were not creating, and benefit those firms with operational problems. In this same connection, the NYSE felt that collection of such data was approaching the point to where the Commission was trying to tell each firm how to run its business.
>
> The NYSE also objected in that the collection of new data would inhibit the effectiveness of the exchange's own self-regulatory duties. Due to the cost of operation and manpower limitations, the NYSE cannot carry on a myraid of regulatory programs. Adoption of this program would therefore require the abandonment of some existing program. The NYSE by adopting this new program in lieu of some of its existing programs would deny themselves the self-regulatory flexibility that they desire. They objected to being "locked-in" to any self regulatory system.
>
> Finally, the NYSE felt that raw or aggregate data is not an accurate means to assess trends in the industry. NYSE data is firm-oriented, as opposed to industry-oriented, because of the great differences in the manner in which brokerage firms operate. The compilation of industry figures on the raw basis would consequently be misleading and faulty.
>
> * * * * * * *
>
> The other regional exchanges in attendance, the Midwest Stock Exchange, the Pacific Coast Stock Exchange, the Boston Stock Exchange, the Detroit Stock Exchange, and the Cincinnati Stock Exchange, generally were in support of

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[142] 1 House Hearings 56.
[143] *Id.*

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the proposal and visualized no substantial problems in its implementation.

The NASD in principle, supported the program. However, it felt that because of its great number of members it would have a problem in administering the program.

The NYSE's memorandum of the October conference was substantively similar to that prepared by the Commission's staff. The Exchange questioned the analytical value of industry aggregate data requested by the Commission and summarized the meeting as follows:

> Bob Bishop stressed the problem of the Commission injecting itself into problem areas and taking over policing and disciplining as a result of their having data comparable to that which we possessed. Commissioner Needham answered, saying detail of this kind would not be part of their enforcement program. Bob also pointed out that SEC having individual firm data on monthly profit and loss might be an unwarranted intrusion on the privacy of securities firms.
>
> I stated that the SEC's position and the use of a common questionnaire raised serious question. I said I felt that a tremendous amount of data was now made available to them, and it was a self-regulatory agency—the Exchanges—that had the prime responsibiilty for the data collection and interpretation, and we had identifiable measures that reflected industry status. I indicated the comments of the SEC staff today were such as to take over the job of the exchanges.
>
> I asked if we were there because the Commission didn't believe our representation about industry progress. I was told no, and that the SEC had the responsibility to better know the degree of improvement than was now available.
>
> The meeting, from the NYSE point of view, was a disaster. With the exception of the AMEX there was no resistance or initiative, but abject submission. I recognize that there is support to the SEC request but I wished it could be picked up by the others as their effort and not a channel of information to the SEC.
>
> I recommend a letter to Needham, copy to Pollack, saying we appreciate what the Commission seeks; that we think it is now being provided; and that future "industry" meetings with others than the AMEX serve no useful purpose. I think we could say that our record is clear, as to cooperation but our methods, procedures and daily operating practices are so superior to the remainder (AMEX excluded) that further efforts of this kind be replaced by meeting directly with the NYSE–AMEX staffs. I would like to try and explain why industry totals for capital or any other area are not really informative. I don't want him to think we are totally negative although much of our comments would lead to that conclusion.[144]

In January of 1970 the Commission renewed its efforts to expedite the flow of information among the self-regulatory agencies. The

[144] NYSE, Memorandum from Lee D. Arning to Messrs. Haack, Cunningham & Calvin regarding SEC Meeting, October 2, 1969 pp. 3–4 (October 8, 1969).

Director of the Division of Trading and Markets questioned the NYSE on its policies regarding furnishing information to other self-regulatory bodies. He wrote:

> We understand that it is the policy of the New York Stock Exchange not to disclose the financial and operational difficulties experienced by your member firms to the National Association of Securities Dealers, Inc. or to the other national stock exchanges of which such firms may be members. The Commission would appreciate receiving a detailed statement of the basis for such policy and the Exchange's view of its responsibility to such other organizations in the event of the insolvency of a dual-member firm.[345]

The Exchange replied that it did, indeed make such information available to other self-regulatory bodies—if they asked:

> Your understanding expressed in your letter of January 16th is not correct. We have been quite willing to make disclosure of the financial and operational difficulties of specific member firms upon inquiry by regional exchanges, of which the firms are also members, or the NASD. We have done so on a number of occasions in the last year. However, we have not made any attempt to keep the other exchanges and the NASD aware of such problems unless they inquire about a member firm.
>
> We attempt to keep their interests in mind in any actions which we take; for example, in the event of an impending suspension. Monday we required one member firm to stop executing orders for about an hour while the status of their bank credit was ascertained. We specifically instructed this firm to stop trading on the other exchanges and the over-the-counter markets as well as our Exchange during that period.[346]

The Commission's files reveal no further correspondence on this subject.[347]

In May of 1970 one of the Commission's regional offices reported that it was having difficulty obtaining timely information about regionally based broker-dealers experiencing financial problems. The regional administrator suggested that a letter be sent to brokerage firms, the NASD major banks, the exchanges and others requesting them to immediately advise the regional office on a confidential basis upon receiving information that a particular broker or dealer was in financial difficulty. Although the Commission's files contain no response to this letter, its recent adoption of rules 17a-5(j) and 17a-11 appears to at least partially implement the regional administrator's suggestion.[348] These rules, among other provisions, require broker-dealers to notify the Commission and the self-regulatory organizations to which they belong when they are experiencing financial or record-keeping problems or when they cease to be members in good standing of an exchange.

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[345] Letter from Irving M. Pollack to R. John Cunningham (January 16, 1970).
[346] Letter from R. John Cunningham to Irving M. Pollack (January 21, 1970).
[347] But see text *infra* at p. 374.
[348] See footnote 139 *supra*.

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In spite of the frustrations of the October, 1969 meeting at the Commission, subsequent meetings were held and real progress has been achieved by the Commission and the self-regulatory bodies. A monthly "Joint Regulatory Report" has been developed to partially eliminate unnecessary duplication among firms which are members of the NYSE or the AMEX and the NASD. Recently the Commission has appointed an advisory committee to devise further methods of eliminating existing duplication in broker-dealer reporting.[149]

D. Informal Bargaining Process

The relationship between the Commission and the New York Stock Exchange under the Securities Exchange Act of 1934 has been described as an "informal bargaining process" in which decisions are "hammered out in closed-door bargaining sessions where vast discretion rests with . . ." the Commission.[150] As the case study points out, during the financial and operational crisis the Commission was successful in this informal bargaining process in some respects and unsuccessful in others. By 1971, the Commission appeared to have gained access to greater information from the New York Stock Exchange files and to have persuaded the Exchange to significantly strengther its financial responsibility rules applicable to member organizati)ns. On the other hand, the Commission and the Exchange were not able to agree on what the Exchange should do when it discovers that a member organization is in violation of rule 325.

Correspondence between the Commission and the Exchange regarding the financial responsibility of member firms discloses other instances of the operation of the informal bargaining process. In the pages which follow are discussions of negotiations between the Commission and the Exchange regarding (a) the prevention of withdrawals of capital from member firms; (b) capital charges ("haircuts") on Canadian government bonds; (c) the inclusion of a disclaimer of liability in NYSE standard form subordination agreements; and (d) the Exchange's position on the treatment of short stock record differences of the firm of F. I. duPont, Glore Forgan & Co.

Capital Withdrawals. In attempting to boost sagging revenues caused by the decline in price and volume in 1970, the NYSE proposed on March 19, 1970 an amendment of its rules requiring member organizations to impose a surcharge in the form of a service fee of $15.00 or 50% of the applicable commission, whichever was the lesser on orders of 1000 shares or less.[151] The Commission, however, had been concerned for sometime about withdrawals of capital from member organizations which had the effect of placing the organizations in or near violation of the net capital rule. The Commission wished to avoid allowing the Exchange to impose a surcharge on the public in the name of fiscal emergency while at the same time permitting Exchange members to withdraw needed capital from their firms. Accordingly, in its letter commenting upon the proposed surcharge, the Commission stated:

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[149] Wall Street Journal, September 27, 1972, page 12, column 3. As to other industry efforts to achieve coordination, see, e.g. Clearance & Settlement of Securities Transactions, Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs, 92d Cong. 2d Sess., pp. 777-801 (1971).

[150] Note, 80 Yale L. Journ. 811, 812 (1972).

[151] See SEC Securities Exchange Act Release No. 8860 (April 2, 1970).

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> We also expect that the Exchange will undertake to make certain that the additional revenues and the interim surcharge will be received by the member firm obtaining the customer's order and will be prudently employed by its member organizations to improve their operation and financial position.[152]

In response to this statement the Exchange required its member organizations to retain the entire surcharge and did not permit sharing such revenues with registered representatives.

In a letter eight days later Chairman Budge elaborated on the Commission's intent, stating that the Commission's acquiescence in the surcharge was predicated upon the Exchange's assurance that the resulting revenues would be prudently employed to retain needed capital within the securities business. He continued, "To accomplish this result, the Commission expects that the Exchange will take prompt action to prevent withdrawals of capital from member firms—unless the prior approval of the Exchange is obtained.[153] Thus, it appeared that the Commission's approval of the temporary surcharge was expressly conditioned upon the Exchange prohibiting withdrawals of capital from member organizations without prior approval of the Exchange first being obtained.

The Exchange, however, did not agree to comply with the condition. On May 1, 1970, Mr. Haack replied to Chairman Budge stating that the terms and conditions under which capital was contributed to member organizations were determined by contractural agreement and not by Exchange rule. Mr. Haack stated that the Exchange would adopt additional procedures, however, designed to assure the retention of necessary capital by its member organizations. He stated:

> The Exchange intends to refuse to approve any proposed withdrawal of capital of which it receives notice in those cases *where it may legally do so* if the withdrawal plus projected operating losses for the next six months would leave the member organization with a capital ratio in excess of 1,500 percent.
>
> Through these procedures, the Exchange will monitor capital withdrawals from member firms prior to the point at which a capital problem is approached and thus prevent the recently instituted service charge from being used to finance improper withdrawal of capital from our member organizations. (Emphasis added.)

Through the following months there was additional correspondence between the Exchange and the Commission regarding withdrawals of capital. The Exchange consistently took the position that it lacked the power to prevent repayment of subordinated borrowings pursuant to "valid enforceable contracts."[154] Four months after Chairman Budge's letter to Mr. Haack regarding imposition of the temporary surcharge the Commission's staff reported as follows:

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[152] Id.
[153] Letter from Hon. Hamer H. Budge to Robert W. Haack (April 10, 1970).
[154] See *e.g.* Unsafe & Unsound Practices Report p. 60. However, it should be mentioned that in at least one instance an Exchange Coordinator did advise a member organization "that effective immediately, all capital withdrawals from your organization are subject to prior formal approval of the Exchange." 2 House Hearings 899.

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> During the period of the surcharge the Exchange's study found that 56 out of 478 firms had limited capital withdrawals. The staff inquired why firms with serious capital problems were repaying capital contributors. The Exchange stated that their counsel had advised them that they could only stop the withdrawals of capital contributions by general partners.

In its Unsafe and Unsound Practices Report the Commission gave examples of capital withdrawals of member firms experiencing financial problems during the period in which the surcharge was in effect.[155] For example, the net equity of general partners of Goodbody & Co. declined from 17.7 million dollars on December 31, 1969 to 12.6 million dollars on June 30, 1970.[156] Over two million dollars of this decline was attributable to withdrawals of capital by retiring partners. As the case study has pointed out, in October of 1970 it was discovered that Goodbody & Co. had an eight million dollar net capital deficiency and that the firm had had capital problems within the knowledge of the Exchange since at least November of 1969.[157]

In spite of the Exchange's statements that it could not comply with the condition which the Commission imposed upon the temporary surcharge, and in spite of the continued withdrawals of capital from member organizations of the Exchange, the surcharge remained in effect. The Commission did not advise the Exchange that the condition had been terminated.

"Haircuts" on Canadian Government Bonds. On April 21, 1970,[158] the same date upon which Messrs. Lasker, DeNunzio, Haack, Cunningham and Stock of the NYSE met with Commissioners Needham, Owens and Smith and several of the Commission's staff regarding the financial condition of member firms,[158] the Exchange submitted pursuant to Rule 17a-8 a proposal to amend its net capital rule regarding "haircuts" on Canadian government bonds. In its letter of submission, the Exchange pointed out that under the existing rule Canadian government bonds were treated the same as corporate bonds with a capital charge ranging from 1 to 30 percent depending upon maturities and ratings. The proposed amendment applied capital charges corresponding to those made on U.S. government securities; *viz.* from 0 to 3 percent. The Exchange explained in detail why it felt that Canadian government bonds were more nearly comparable to U.S. government securities for purposes of capital charges.[159]

On May 26, 1970 (two weeks after the expiration of the three-week notice period required by Rule 17a-8) the Commission furnished its comments on the proposed amendment to NYSE rule 325, stating in relevant part:

> The proposed amendment would relax the requirements of the Exchange's net capital rule by reducing the haircuts applicable to Canadian Government obligations. It should be pointed out that prices of Canadian Government obligations may fluctuate as rates of interest and monetary con-

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[155] Unsafe & Unsound Practices Report, pp. 61–63.
[156] *Id.* at 62.
[157] See text *supra* at p. 351.
[158] See text, *supra* at p. 348.
[159] Letter from Fred J. Stock, Jr., Assistant Vice President, & Associate Director, Department of Member Firms to Irving M. Pollack (April 21, 1970).

version change, accordingly, [sic] affect a firm's liquidity if it has such securities in its proprietary accounts.

Furthermore, since the date of your letter the Division has sent a letter dated April 29, 1970 [see case study text *supra*. pp. 233–234] to the Exchange regarding its net capital rule. In view of the concern we have expressed with respect to deficiencies in the application of the Exchange's net capital rule in that letter, we believe the Exchange should not be relaxing the requirements of its rule. However, if you wish, the staff would be glad to discuss this proposed amendment in greater detail in the context of the overall comprehensiveness of the Rule 325.[160]

By the time the Commission's letter of comment was prepared, however, the proposed amendment had already been approved by the Board of Governors of the NYSE. Accordingly, the Exchange advised the Commission on June 2, 1970, "We were quite surprised at the position taken in your letter of May 26, but since this rule had already been amended by the Board of Governors, we feel that there is nothing more to be done at this time." [161]

In an apparent attempt to protect the record, the Associate Director of the Division of Trading and Markets responded on June 11, 1970 as follows:

In my conversation with you, I indicated only that we were considering this proposed amendment and requested an extension of time for our comments. I understand that this request had been granted and that you would await our comments.

Accordingly we sent you our letter of May 26. *Our position as expressed in that letter remains unchanged.* (Emphasis added.)

The Commission's files reveal no further correspondence regarding the "haircuts" imposed by the NYSE on Canadian government securities. No action was commenced against the Exchange to compel it to amend rule 325 consistent with the Commission's position.

Subordination Agreement—Disclaimer of Liability. The amendments to NYSE rule 325 which culminated in the broad scale net capital amendments of July, 1971 were submitted to the Commission in two separate packages ("Phase I" and "Phase II") by the Exchange.[162] The Phase II amendments, which included proposed printed standard forms for subordinated loans (which, under certain circumstances may be counted as capital in computing the net capital ratio), were mailed to the Commission on February 19, 1971.[163] Each of the proposed standard form subordination agreements was subject to a provision similar to the following:

Non-Liability of Exchange. The Note is not being made and this agreement is not being entered into in reliance upon the standing of the Organization as a member organization of the Exchange or upon the Exchange's surveillance of the

[160] Letter from Irving M. Pollack to Fred J. Stock, Jr. (May 26, 1970).
[161] Letter from Fred J. Stock, Jr. to Irving M. Pollack (June 2, 1970).
[162] See text *supra* at p. 356.
[163] Letter from Robert M. Bishop to Irving M. Pollack (February 19, 1971).

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> Organization's financial position or its compliance with the constitution, rules and practices of the Exchange. The undersigned has made such investigation of the Organization and its partners, officers, directors and stockholders as the undersigned deems necessary and appropriate under the circumstances. The undersigned is not relying upon the Exchange to provide any information concerning or relating to the Organization and agrees that the Exchange has no responsibility to disclose to the undersigned any information concerning or relating to the Organization which it may now, or at any future time, have. The undersigned agrees that neither the Exchange, its Special Trust Fund nor any governor, officer, trustee or employee of the Exchange or said Trust Fund shall be liable to the undersigned's capital contribution or the repayment thereof or of any interest thereon.[164]

When the Commission responded to the initial Phase II proposals it strenuously objected to inclusion of the quoted language in the subordinated lending documents on the ground that the provisions violated the policies underlying the federal securities laws. The Commission's letter stated:

> These provisions are against public policy and constitute an improper attempt to circumvent the Securities Exchange Act provisions which make the Exchange responsible for policing the financial responsibility of its members and also make the member firm liable for its failure to comply with the federal securities laws and with Exchange rules, constitution and policies.[165]

After meeting with Chairman Casey, Commissioner Needham and various of the Commission's staff on May 24, 1971 to discuss the Phase I and Phase II proposals in detail, the Exchange submitted revised proposals on May 28, supported by a six-page letter explaining the important provisions of the various rules.[166] The letter did not mention the exculpatory clause in the subordination agreements to which the Commission had so strenuously objected in April. However, the subordination documents attached to the letter were identical to those contained in the original submission of February 19, 1971 except that the exculpatory clause in the Secured Demand Note Collateral Agreement had been altered to provide not only that the Exchange had no duty to provide information about the member organization but that it has no duty to *cause* such information to be provided by anyone else.[167]

When it commented upon the revised proposals the Commission congratulated the Exchange on having strengthened its rules and made some additional suggestions for improvements.[168] Referring to the exculpatory clause in the subordination agreements the letter stated:

> We again call your attention to our opinion that the exculpatory clause in this and the other printed loan agreements are against public policy and constitute an improper attempt

[164] *Id.* (attached Secured Demand Note Collateral Agreement at p. 5).
[165] Letter from Irving M. Polack to Robert M. Bishop, p. 4 (April 20, 1971).
[166] Letter from Robert M. Bishop to Irving M. Polack (May 28, 1971).
[167] *Id.* (attached Secured Demand Note Collateral Agreement at p. 5).
[168] See text *supra* at p. 357. The letter of comment was unanimously approved by the Commission on June 17, 1971. SEC, Minutes of a Meeting held June 17, 1971.

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> to circumvent the Securities Exchange Act provisions and judicial decisions which make the Exchange responsible for policing the financial responsibility of its members and also make the member firms liable for failure to comply with the federal securities laws and the Exchange rules, constitution and policies.[169]

On July 15, 1971 the NYSE advised the Commission that the proposed amendments to the net capital rules had been adopted by the Board of Governors and that several changes had been made pursuant to the Commission's most recent letter of comment.[170] Again the Exchange's letter did not refer to the exculpatory clause to which the Commission had objected. Again the subordination documents did contain the clause.[171]

The Commission's files contain no further correspondence regarding the exculpatory clause contained in the NYSE subordination documents. The Commission has taken no action to compel removal of the clause from the documents.[172]

F. I. duPont, Glore Forgan & Co.; Short Stock Record Differences. The last of the near disasters of the financial and operational crisis concerned the firm of F. I. duPont, Glore Forgan & Co., the third largest NYSE member organization. The firm's problems apparently dated back to 1967 and finally came to a head in 1970 and early 1971.[173] In order to save the firm by bringing in outside capital, the NYSE made several special arrangements including an exception to its rule on control of member organizations by persons outside the securities industry.[174] By one report an injection of 79 million dollars was ultimately required to rescue the duPont firm.[175]

One of the special arrangements made by the Exchange in connection with the investment in duPont by H. Ross Perot interests was a temporary agreement to make no charge for short stock record differences in computing the firm's net capital ratio so that the firm would have an opportunity to research the differences. In January of 1971 Commissioner Owens wrote to the Exchange regarding the serious financial condition of duPont. Among other matters, he stated, "We further would like to know what steps the Exchange will take to compel the firm to make an adequate charge against capital for short stock record differences and any similar items and to make a computation of its capital on at least a monthly basis."[176]

In its reply the Exchange reported that the duPont firm had $15.5 million in short stock record differences at January 29, 1971, and continued:

> It is our understanding that Mr. Meyerson of PHM spoke to the SEC regarding the capital charge for 1970 short secu-

[169] Letter from Irving M. Pollack to Robert M. Bisbop, p. 9 (June 17, 1971).
[170] Letter from Fred J. Stock, Jr. to Irving M. Pollack (July 15, 1971).
[171] See 1 House Hearings 240, 243–244, 249, 256–257, 259, 265, 271–272, 274–275.
[172] It is important not to lose sight of the fact that, through the informal bargaining process the Commission and its staff were able to cause a significant strengthening of the NYSE rule in other areas as compared with the previously existing rule or the originally proposed amendments. See text *supra* at p. 357.
[173] See, e.g. H. Baruch, Wall Street: Security Risk 241 (1971). See also text *supra* at p. 357.
[174] See, e.g. Securities Industry Study, Hearings before the Subcom. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs, 92d Cong., 1st Sess. at 159 (1971).
[175] Greer, *F. I. duPont Rescue Cost $79 Million*, The Washington Post, April 7, 1972, at D12, col. 4.
[176] Letter from Hon. Hugh F. Owens to Robert W. Haack, p. 2 (Jan. 29, 1971).

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rity differences and reported to us that the SEC has sanctioned the current reserve until at least June. At that time we would require that the reserve equal the then existing short differences.[177]

Again, on March 9, 1971 the Exchange reiterated its understanding that the Commission had acquiesed in making a temporary dispensation in the case of the duPont firm:

> As to the specific circumstances of the duPont, Glore Forgan & Co. differences, we can simply restate that which we understand to be the case—that at a meeting with Commissioners in November 1970, at which Mr. Lasker was present, the status of the existing reserves for short security differences at F. I. duPont, Glore Forgan & Co. was a subject of discussion. We understood that the continuance of the current level of these reserves was sanctioned at least until June 1971.[178]

The Commission, however, did not agree to the special treatment of short stock record differences in the case of the duPont firm. On March 19, 1971 Commissioner Owens replied to Mr. Haack's letter of March 9, as follows:

> We are writing in response to your letter of March 9, 1971 concerning F. I. duPont, Glore Forgan & Co. As was pointed out in our recent conference with you and other Exchange representatives and in our prior letter, *the Commission has not given any sanction to the Exchange's position on the treatment of the firm's short stock record differences for purposes of computations made under the Exchange's net capital rule.* The Commission recognizes this is primarily a matter for the Exchange's determination under its existing rules.
>
> The Commission again wishes to express its concern at the apparent lack of progress being made in straightening out the firm's operational problems. The results of the recent box count do not give us confidence that the firm is in fact adequately processing current transactions, or that its books and records are current. We trust that the Exchange will be vigilant in its monitoring in this area as well as the financial area, and that it will insist upon substantial progress being made within meaningful time schedules. (Emphasis added.) [179]

On April 28, 1971 the Exchange advised the Commission in detail of the final arrangements that had been made with the duPont firm regarding the charging of short stock record differences for purposes of capital computations. The agreement adopted a formula for treatment of such differences depending upon when they were incurred and gave the firm until April of 1972 before full charges would be made.[180]

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[177] Letter from Robert W. Haack, to Hon. Hugh F. Owens, p. 2 (Feb. 9, 1971).
[178] Letter from Robert W. Haack to Hon. Richard B. Smith (Mar. 9, 1970).
[179] Letter from Hon. Hugh F. Owens to Robert W. Haack (March 19, 1971).
[180] Letter from Robert W. Haack to Irving M. Pollack, p. 3 (April 28, 1971).

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Again on August 20, 1971 the Exchange reminded the Commission of the special treatment being afforded short stock record differences of F. I. duPont & Co.[181] In September of 1971 the Commission's staff estimated that, under the Commission's net capital rule at least, du Pont had a $16 million net capital deficiency even after the capital infusions by the Perot interests. Due to the contribution of large amounts of additional capital, the duPont firm is now reported to be in sound financial condition. There is no record of the Commission's having taken any action to enforce the position taken in its non-acquiesence of March 19, 1971.

[181] Letter from Richard B. Howland, Executive Vice President NYSE to Hon. William J. Casey, p. 2 (August 20, 1971).

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NET CAPITAL POSITION OF
McDONNELL & CO. PER TRIAL EXHIBITS

AS OF DATE	McDONNELL & CO.	NEW YORK STOCK EXCHANGE	LYBRAND & CO	TRIAL EXHIBIT	DATE OF EXHIBIT
6/27/68	1776%	1837%		73	8/20/68
7/26/68	1590%			71	8/28/68
8/26/68	1354%			71	8/28/68
10/31/68		$1,700,000 over 2000%		37	1/13/69
		3992%		AA	1/27/69
		3992%		39	1/28/69
		2717%		39	1/28/69
		2717%		74	2/7/69
		3565%		25	4/24/69
		2512%		25	4/24/69
		2512%		BB 83	10/22/7[illegible]
1/30/69		3825%		23B	4/18/69
		3825%		25	4/24/69
		5525%		25	4/24/69
		3920%		25	4/24/69

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NET CAPITAL POSITION OF
McDONNELL & CO. PER TRIAL EXHIBITS

AS OF DATE	McDONNELL & CO.	NEW YORK STOCK EXCHANGE	LYBRAND & CO.	TRIAL EXHIBIT	DATE OF EXHIBIT
3/24/69	1587%	2014%		52	4/7/69
3/27/69		2920%		23B	4/18/69
		2629%		23B	4/18/69
		2522%		23B	4/18/69
7/31/69	2151%	20,339%		EEE	9/4/69
		5278%		EEE	9/4/69